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Debunking the Corporate Fiduciary Myth

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I. INTRODUCTION

The doctrine of corporate fiduciary obligation—which holds that corporate officers and directors are fiduciaries of the corporation and its shareholders and are disciplined primarily through the enforcement of fiduciary duties—has been the core basis of all corporate law. However, today that doctrine is little more than a fiction. The emperor wears no clothes. The common law has developed in such a way that the relationship among corporate officers, directors, and the firm should no longer be characterized as a fiduciary one. Corporate managers[1] are not entrusted with "open-ended" control,[2] and corporate practice has gone beyond the expectation that managers will put the shareholders' or corporation's best interests before their own. It is now customary to assume that managers will hold their own personal interests paramount and to exploit that self interest by using incentive compensation as a way to direct managerial behavior and decision-making. Such employment incentives and market forces do far more to monitor corporate decision makers than any supposed sense of loyalty or fiduciary obligation. When market forces can or do adequately constrain agency costs, the relationship in question is no longer properly regarded as fiduciary.[3]

At first blush, applying fiduciary principles to corporate governance seems like a natural fit. The officers and directors of a corporation do not own the corporation or its assets. Instead, they manage them for the benefit of the corporation's investors. A fiduciary relationship often exists when one person or entity is entrusted with acting for the benefit of another and so is called upon to eschew self interest in favor of the best interests of the beneficiary.[4] When one person or entity is entrusted with a power over the well being of another, the potential for abuse of that power can define the relationship as fiduciary.[5] Fiduciary relationships are, therefore, defined by the relative vulnerability of the beneficiary. The efficacy of the fiduciary obligation is not in providing every particular of faithful fiduciary behavior; rather, it is the opposite—trusting the fiduciary's

1. In this paper, "managers" refers to officers and directors collectively.

2. Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 217 (naming the open-ended control granted corporate managers as the primary justification for the use of fiduciary duties to constrain their behavior).

3. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1067 (1991) (pointing out that fiduciary relationships give way to market exchange when contracts provide the proper incentives); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993) [hereinafter Easterbrook & Fischel, *Fiduciary Duty*] (arguing that contractual relationships are only fiduciary where it is prohibitively expensive to negotiate the necessary terms).

4. TAMAR FRANKEL, FIDUCIARY LAW 96–97 (2007).

5. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 808 (1983) ("[T]he risk of abuse which all fiduciary relations pose for the entrustors is the main feature which triggers the application of fiduciary law, when the protective mechanisms outside of fiduciary law cannot adequately eliminate this risk.").

judgment and having the flexibility to check the fiduciary's behavior any time it deviates from serving the beneficiary faithfully. Such flexibility has long made fiduciary duties an effective way to monitor those who have been granted open-ended control over the assets or well being of others. Beneficiaries want to rely on someone else's expertise and think it is in their best interests to trust, rather than directly control, the fiduciary. This focus on trust rather than direct monitoring or control is the hallmark of fiduciary law.

This Article does not suggest that the concept of fiduciary obligation is not important to corporate law.[6] However, instead of serving as a guiding principle for corporate doctrine, fiduciary principles are the obstacles around which much of the law of corporate governance must maneuver. It is in spite of, rather than because of, corporate fiduciary duties that corporate law has developed. Because managerial independence is so important and shareholder interference in business decisions is potentially harmful, the fiduciary obligation has been weakened and very narrowly defined.[7] One important attribute of fiduciary duties is their flexibility and ability to address unpredictable problems. That sort of amorphous standard does not suit corporate governance. The poor fit means that we deny corporate governance duties the kind of enforcement that would make them truly fiduciary. Narrowing the scope of fiduciary obligation and applying it to only very few and very specific situations undermines the benefits of using fiduciary obligation in the first place. The conventional wisdom has cast too wide a net in defining corporate fiduciary duties and so has failed to realize that their limited purposes could be better served through contractually enforced rules and standards of managerial behavior.

Scholars have grappled with how best to characterize corporate fiduciary duties and to what object those duties should be enforced.[8] One view rests its understanding of fiduciary duties on moral grounds: directors are in a position of trust and confidence and so should be held to a high, legally enforceable standard of trustworthiness.[9] Somewhat related to that first view is another that focuses on the role of fiduciary duties in reducing agency costs associated with the separation of ownership and control inherent in the corporate form.[10] This view argues that fiduciary duties exist as a means to hold directors and officers more accountable, or to offer another layer of protection against the opportunity they have to abuse their position by using the assets under their control for personal, rather than corporate, gain.[11] A third group focuses its analysis on the economic, contractarian view of corporate law.[12] It argues that fiduciary duties are useful gap fillers in the contracts that make up the corporation and exist because parties to a

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6. For the purposes of this Article, the terms "fiduciary relationship," "fiduciary duty," and "fiduciary obligation" refer to *legal* relationships, duties, and obligations. Other duties, such as moral duties or those implied by social norms, are beyond the scope of the argument.

7. *See infra* Part II.A.

8. *See, e.g.*, Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3; DAVID COWAN BAYNE, S.J., THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY (1986); Frankel, *supra* note 5; Ribstein, *supra* note 2; Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997) [hereinafter Brudney, *Contract and Fiduciary Duty*]; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879.

9. *See generally* BAYNE, *supra* note 8.

10. *See generally* Frankel, *supra* note 5; Ribstein, *supra* note 2; J. C. SHEPHERD, THE LAW OF FIDUCIARIES (1981).

11. *See generally* Frankel, *supra* note 5; SHEPHERD, *supra* note 10.

12. *See generally* Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3.

contract could never provide for every contingency in advance.[13] Fiduciary duties fill inevitable gaps in contracts and should be interpreted in light of what the parties would have agreed to had they explicitly negotiated terms providing for the situation before the court.[14] When we hold the application of corporate fiduciaries up to any of these theories of fiduciary obligation, we see that the current enforcement of corporate fiduciary duties does not fit into any of the available molds. Despite the understandable assumptions to the contrary, it appears that fiduciary obligation is not really the preferred means to the stated ends of corporate governance law and policy. Importing traditional fiduciary principles into the law of corporate governance brings far more baggage than fits. This realization has led some scholars to conclude that corporate fiduciary duties should be eliminated,[15] but those commentators fail to realize that the fiduciary character of the corporate governance relationships is already gone.

The use of the term "fiduciary" in corporate governance is a misnomer. It is dangerous and costly to assume that fiduciary duties function well in the corporate context. The assumption may give shareholders a false sense of security or a belief that they are able to discipline management effectively when in fact, because of the very limited nature of corporate governance duties, they are not. Also, the assumption may leave a gap in monitoring and accountability that could otherwise be filled. The misdeeds that currently constitute breaches of fiduciary duty could be punished, prevented, and redressed in much more effective and economically efficient ways. If we accept that the corporation is a nexus of contracts, then all investors should be equally free to negotiate the terms of their investment and their attendant control over management, just as creditors do.[16] This gives us the freedom to toss aside the traditional view of corporate organization and ask: What would happen if shareholders were just the most junior creditors? What if shareholders could negotiate with management about the rights they would have over corporate governance? To that end, an "equity trustee," much like an indenture trustee representing widely dispersed bondholders, can represent shareholders to management and remain informed on their behalf.[17] Through the enforcement of agreements reached on the shareholders' behalf by an equity trustee and agreements providing for the rights of other investors, corporate constituents can monitor and discipline corporate officers and directors more efficiently and effectively in a post-fiduciary world than they have been able to thus far. When all investors can negotiate contracts with the corporation that monitor and discipline corporate managers to the extent allowed under corporate law, the enforcement of those investment contracts will replace fiduciary duties as the dominant corporate governance mechanism.

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13. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 426–27; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) [hereinafter EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE]. This view has been associated with the agency costs theory, but Easterbrook and Fischel take it a step further, claiming that "[a]gency is a necessary but not sufficient condition" to require fiduciary duties. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 436. They argue that "[i]f agency were sufficient, then all business relations would be fiduciary, and the category would lose its distinctive quality." *Id.*

14. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 427.

15. Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1333 (2008).

16. *Id.*

17. Kelli A. Alces, *Strategic Governance*, 50 ARIZ. L. REV. 1053, 1095 (2008) [hereinafter Alces, *Strategic Governance*].

This Article proceeds in three parts. Part II considers the state of corporate fiduciary duties now. It considers to whom those duties are currently owed and then reviews in turn each of the "fiduciary" duties defined by Delaware corporate law. It concludes that the conventional wisdom assumes that corporate fiduciary duties do more than they actually can do. Part III then applies the prevailing theories about the meaning and purposes of fiduciary relationships to the relationship between corporate managers and the firm as it is currently construed. It concludes that regardless of the theory of fiduciary relationships applied, corporate fiduciary duties fall short and that the corporate governance relationships are not, in fact, fiduciary in nature. Use of the term "fiduciary" to describe the duties owed to the firm by corporate management implies broader duties than actually exist without specific contract terms requiring them and does more harm than good. Part IV describes new corporate governance mechanisms that can help firms overcome and adapt to the absence of fiduciary duties. It suggests methods of ordering corporate relationships so that fiduciary duties are not missed. The Article concludes by observing that although corporate fiduciary duties may have become obsolete, corporate governance is alive and well and developing new, more efficient and effective methods of monitoring and disciplining corporate managers.

II. CORPORATE FIDUCIARY DUTIES

Fiduciary duties are considered the fundamental mechanism for monitoring and disciplining corporate officers and directors, and appear to do the most to fix the standard of behavior governing those corporate leaders. Fiduciary litigation is the tool shareholders use to challenge improvident managerial decisions. The importance of fiduciary duties and their efficacy as a tool to protect shareholder interests is just an illusion, however. While fiduciary language guides many areas of corporate law, fiduciary principles are not really a force in their own right. That is, fiduciary duties are not relied upon to discipline managers, and they are not enforced very often. Over time, the Delaware common law and the actions of corporate officers, directors, and investors have narrowed corporate fiduciary duties to the point of irrelevance and obsolescence.

This Part will explore the contours of the current fiduciary duty jurisprudence in Delaware corporate law.[18] It will describe to whom corporate fiduciary duties are purportedly owed and in whose favor they are enforced. The common understanding is that corporate officers and directors owe fiduciary duties to the firm and its shareholders.[19] While courts are willing to enforce some corporate governance standards and requirements, there are no strictly fiduciary duties. Where a duty or relationship need not be fiduciary because the relationship is adequately governed by non-fiduciary mechanisms, it is not "fiduciary" at all.[20] There are better mechanisms policing management now, and even better mechanisms on the horizon, so the time has come to admit that fiduciary duties have fallen out of favor and move forward without them.

18. This Article focuses on Delaware law because the vast majority of large, public corporations, the subject of this paper, are incorporated there, and it makes the vast majority of law affecting public corporations.

19. BAYNE, *supra* note 8, at 141–42.

20. Cooter & Freedman, *supra* note 3, at 1067.

A. What are Fiduciary Duties?

It is necessary at the outset to fix a notion of fiduciary obligation. All fiduciary relationships are, at some level, contractual. The fiduciary agrees by contract to take on a particular task and assume fiduciary duties in the performance of that task. A party decides to bind another to fiduciary duties because the nature of the task undertaken is such that some degree of trust is required. The beneficiary of the relationship is in a vulnerable position and either does not know enough about what the fiduciary will be doing to monitor properly, or does not have the time to monitor the fiduciary carefully. This vulnerability and lack of monitoring ability combine to cause the parties to enter into a relationship of trust and confidence, one in which the fiduciary must put the beneficiary's interests above his own in the performance of the task. The ways in which the fiduciary goes about doing so are not spelled out, but are left to ex post judicial review. Some would argue that it is this necessity for ex post review brought on by the incomplete nature of the contract at issue that makes the relationship fiduciary.[21] The two definitions fit together. In filling the gap, the judge must try to reach a decision that approximates what the parties would have agreed to had they considered the issue themselves. Calling the relationship "fiduciary" tells the judge that the original understanding between the parties was that the fiduciary would be held to a higher standard of trust and an obligation to work in a trustworthy manner for the benefit of another, with that beneficiary's best interests as its goal in the performance of the task. This gives the judge a framework for crafting the hypothetical bargain.

Fiduciary relationships are distinguishable from contractual relationships that do not contain fiduciary terms because the non-fiduciary contracts (call these "contractual," rather than fiduciary, relationships) are governed by precise terms and a comparatively low standard of good faith and fair dealing. There is a limit to the extent to which parties in a contractual relationship can take advantage of each other or their relative positions, and they are expected to try, in good faith, to honor their contractual obligations, but remedies for disappointing performance are limited by the terms of the contract and to appropriate and measurable damages. If I hire someone to build a garage for me, I do not have the expertise to monitor him carefully or to tell him exactly how to perform the task, but I can hold him liable for obvious deficiencies in the product of his efforts, and I can limit my exposure to costs occasioned by his shirking by setting a reasonable price in advance. I cannot knowledgeably monitor the contractor, and I cannot give him precise instructions. Instead, I must rely on his expertise and trust that the job will be performed well. If it is not performed satisfactorily, I may be able to recover what I've paid him or damages I suffer by enforcing our contract. No one would consider this a fiduciary relationship, even though there are obvious points at which the contractor could take advantage of my lack of expertise and monitoring. For example, he could take frequent and long breaks, use cheaper materials, or hire sub-standard workers. It is not the differential in expertise, the inability to monitor, the inability to contract for precise instructions, or even the ability to take advantage of those circumstances that make a relationship fiduciary.

Instead, a fiduciary relationship puts both parties on notice that the relationship will

21. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 427.

rely on a higher standard of trust, and the fiduciary will be held to a higher standard in serving the beneficiary's interests than would the ordinary contractor. A fiduciary has an obligation to work in a trustworthy manner for the benefit of another, with that beneficiary's best interests as its goal, and with the kind of care and attention the beneficiary would exercise if acting on his own behalf. Loyalty means more than lack of direct financial conflict and more than a lack of opportunistic behavior. While the duty of care is not uniquely fiduciary, it would be incongruous to conclude that a fiduciary should not be held to a meaningful standard of care. The level of trust that guides courts in filling the gaps in fiduciary relationship requires that fiduciary standards be flexible and easily adaptable to unpredictable circumstances. That is their chief benefit. We may not be able to define in advance all of the ways in which a fiduciary may be untrustworthy, but we know disloyal conduct when we see it.

The foregoing formulates the conception of fiduciary obligation and fiduciary relationships that animates this Article's discussion of whether corporate governance relationships are fiduciary. I conclude that corporate officers and directors are more like building contractors than they are like trustees, agents, or any other kind of traditional fiduciary and that traditional notions of fiduciary obligation do not square with the relationship between corporate managers and the firm as it currently exists.

B. To Whom Are Fiduciary Duties Owed?

The first step in determining whether there is a fiduciary relationship is to determine to whom fiduciary duties, if any, would be owed. In order to establish a fiduciary relationship, there must be a fiduciary and an "entrustor," or a beneficiary of the fiduciary's obligations and duties, that is, the person or entity on whose behalf the fiduciary is acting.[22] While some scholars maintain that fiduciary duties are owed to shareholders,[23] more recent theories have begun to coalesce around the notion that to the extent officers and directors owe fiduciary duties, they owe those duties to the corporation itself, however defined.[24] Conventional wisdom holds that corporate officers and directors owe fiduciary duties because they are managing the assets of others, and to the extent the firm's shareholders are the owners of the company, it is those shareholders' assets that officers and directors are managing.[25] If the owners of a corporation need to retain experts to manage the business for them because they do not have the skills to manage the business themselves, then those experts will be charged with doing so on

22. Frankel, *supra* note 5, at 800.

23. *See generally* Julian Velasco, *Shareholder Ownership and Primacy*, 2009 U. ILL. L. REV. (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1274244 (defending the traditional view that shareholders own corporations and that a corporation's directors have a fiduciary duty to shareholders); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002) (discussing implications of director primacy as it relates to various corporate legal doctrines).

24. *E.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299 (1999); Baird & Henderson, *supra* note 15, at 1322.

25. Velasco, *supra* note 23, at 1, 14; Baird & Henderson, *supra* note 15, at 1312 ("[T]he reasoning needed to navigate around the sacred cow that the duty of directors is owed solely to the shareholders has become increasingly awkward.").

behalf of its owners, and with the owners' best interests at heart.[26]

Lately, every part of this conventional wisdom is under attack. It is no longer accepted as necessarily true that shareholders own a corporation any more than any other kind of investor does.[27] To that end, it is not particularly clear that the corporation should be operated on the shareholders' behalf or with particular regard to their unique interests or preferences. Indeed, scholars and courts alike have moved toward an understanding of corporate fiduciary duties which dictates that fiduciary duties are owed to the corporation as a whole and that the interests or preferences of one constituency should not be honored above others.[28] This hesitance to place the shareholders' interests above all others seems to negate any claim that there are fiduciary duties owed particularly to them.[29]

In *Other Peoples' Money*, Professors Douglas Baird and Todd Henderson contend that directors no longer owe a fiduciary duty to shareholders and show that courts refuse to impose liability for breach of fiduciary duty in a way that requires a preference for shareholder interests above all others.[30] Baird and Henderson point out that directors can make a number of decisions that particular shareholder interests oppose, and that actually harm shareholders, for the benefit of other investors.[31] They list several examples of this phenomenon, including: the decision to file bankruptcy, the ability of directors to structure a merger so as to remove the shareholders' right to vote on it and the provision of appraisal rights to compensate shareholders who were forced to give up their shares against their will.[32] All of those facts about the state of shareholders' relationship to management and rights against management conflict with traditional understandings of enforceable fiduciary duties. For example, a beneficiary of fiduciary duties can hold the fiduciary liable for preferring the interests of others above his own and can require that the fiduciary not act contrary to the beneficiary's interests at all, particularly not for the benefit of a party to whom fiduciary duties are not owed.[33]

Baird and Henderson also argue that all investors should be created equal, that is, all investors own the corporation and so the company is operated on behalf of all of them, and no one group of investors should benefit from a greater allegiance from management

26. Velasco, *supra* note 23, at 1, 14.

27. Baird & Henderson, *supra* note 15, at 1310–11.

28. Blair & Stout, *supra* note 24, at 299; Baird & Henderson, *supra* note 15, at 1322 ("The important pressure point here is the word 'corporate,' which speaks to the value of the corporation as a whole as opposed to the value of its constituent parts."); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). For a discussion of cases affirming that even within the zone of insolvency, fiduciary duties are owed only to the corporate entity, see Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529, 538–44 (2007).

29. Shareholders can sue directors directly for breach of fiduciary duty if the managers have made a decision that compromises the shareholder's individual rights as shareholders, or if a handful of shareholders suffer a unique injury at the hands of management that is not shared by all. Perhaps such suits could be better cast as suits to enforce shareholder rights, or enforcement of terms of the corporate contract with shareholders. Then again, the duty at issue need not be fiduciary in nature. It is simply a duty to make a good faith attempt at preventing the corporation from breaching its contract with shareholders. The existence of direct suits acknowledges that shareholders have enforceable rights, but does not prove that they are beneficiaries of fiduciary duties.

30. Baird & Henderson, *supra* note 15, at 1312 n.17.

31. *Id.* at 1316–17.

32. *Id.* at 1316–20.

33. Baird & Henderson, *supra* note 15, at 1326.

than the others.[34] The duty that officers and directors owe is one to maximize the firm's value. That goal may be accomplished in ways that shareholders would not find preferable or may not be solely in the shareholders' interests.[35]

If we acknowledge that shareholders are not beneficiaries of particular fiduciary duties and question whether they are really "owners" of a firm,[36] then we must see that we have moved beyond the traditional understanding of corporate fiduciary duties. Directors are not fiduciaries of the shareholders. While what is good for the residual claim is often good for corporate wealth maximization, common goals alone do not give rise to a fiduciary relationship. Fiduciary relationships require a clear beneficiary who can enforce certain obligations of loyalty, that is, a beneficiary who can insist that its interests are preferred above all others and are the singular focus of the fiduciary's efforts on the beneficiary's behalf.[37] In our ever-changing and increasingly complex corporate world, directors and officers simply do not act "on behalf" of shareholders. Rather, their duty, to the extent *fiduciary*, seems to be owed to the corporation.

What does it mean for directors and officers to owe fiduciary duties to a corporation? What is the corporation? Whether we see a corporation as a nexus of contracts[38] or a team of actors making firm-specific investments,[39] a corporation is a collection of various contributions and interests, many of which are competing with one another for favor, resources, or influence.[40] Such a juggling act is difficult for corporate managers, and such an amorphous and unspecific definition of beneficiary is unusual in the law of fiduciary relationships.[41] As long as managers act in good faith and are not benefitting themselves to the detriment of the corporation, that is, enhancing their personal wealth while diminishing corporate wealth, then the business judgment rule protects any decisions they make along the way, including decisions about which constituent's interests or preferences to favor.

For example, the tensions between different groups—predominantly creditors and

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34. *Id.* at 1327.

35. *Id.*

36. A right to a residual claim may not necessarily convey ownership. It is not entirely clear why shareholders in a troubled company should be considered "owners" any more than creditors who hold security interests in the vast majority of the firm's assets and enforce loan covenants that control some corporate business decisions and practices. *See id.* at 1311 n.10.

37. FRANKEL, *supra* note 4, at 99–101.

38. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9 (2002) (describing the nexus of contracts theory as the dominant model of the corporation among legal scholars, and placing its origins in Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386 (1937)).

39. Blair and Stout argue that the mediating hierarchy corporate structure encourages all team members to reach collective goals when team members are personally invested in the dispute resolution process and have a say in the "allocation of duties and rewards." Blair & Stout, *supra* note 24, at 278–79. Additionally, harmony is more readily reached when the team itself has ultimate control over who its members are. *Id.*

40. *Id.*

41. David Bayne compares the fiduciary relationship loosely to the relationship of marriage since the duties and the trust in a marriage are so intertwined that they are virtually inseparable. The distinction lies, however, in the fact that marriage is based on mutual duties whereas corporate duties are unilateral, and it is very clear who the beneficiaries of marital duties are. BAYNE, *supra* note 8, at 109. The fact that duties and trust are so inextricably connected could be a primary reason for the confusion of directors because many parties trust the directors to exercise good faith in their decision making, but fiduciary duties are not necessarily owed to all of those constituents.

shareholders—become particularly acute when a corporation is in financial distress, or within what is referred to as the "zone of insolvency."[42] Courts faced with the question of whether directors have breached a duty by preferring creditors' interests to shareholders' have answered that they have not[43] and, indeed, have encouraged managers to serve the "community of interests" that represents the corporate enterprise.[44] Considering the community of interests as a whole and conceiving of the corporate enterprise as the beneficiary of fiduciary duties can, in most cases, give managers a definite and somewhat quantifiable goal: value maximization.[45] As long as managers are working toward maximizing the corporation's value and refraining from indulging in conflicts of interest, they are fulfilling their duties to the corporation. They can make decisions aimed at achieving value maximization in various ways; they can adopt any number of constituents' preferred methods of doing so, or choose a course that no one interest in the community would necessarily prefer.[46] Giving directors and officers this common goal defines the scope and aim of their duties and, in a way, makes them seem more like trustees with a common, identifiable beneficiary. Here, the beneficiary is not a particular "interest" or "entity," but a goal, a general product of managerial decisions. To the extent that officers and directors owe a fiduciary obligation now, that duty is obliged to the corporate enterprise.[47] The duties as they remain are quite limited, even in spite of recent threats to expand them.[48] When we reduce those duties to their essence, we see that they need not be fiduciary duties at all, and if they need not be, they are not.[49]

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42. Alces, *Strategic Governance*, *supra* note 17, at 1055–56 (noting that when the corporation is in financial difficulty, shareholders become very risk preferring, and creditors want the corporation to be even more risk averse). The zone of insolvency is "that time in a corporation's life when insolvency is imminent. Because it is not possible to determine the exact moment a corporation becomes insolvent, courts and creditors speak of the zone of insolvency when talking about the time during which a switch to creditor preferences may be appropriate." *Id.* at 1055 n.8.

43. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

> [D]irectors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make . . . .

Id.

44. *Id.*

45. Baird and Henderson compare fiduciary duties to trustee duties, and conclude that where trustees must sometimes consider the individual needs and interests of the beneficiaries, in the corporate context, value maximization is a "suitable benchmark" combined with the protections of the business judgment rule. Baird & Henderson, *supra* note 15, at 1327–28.

46. Alces, *Strategic Governance*, *supra* note 17, fig. 2.

47. Blair & Stout, *supra* note 24, at 298 ("[D]irectors generally will be subject to liability only for conduct that harms not just shareholders, but the corporate coalition as a whole.").

48. *See infra* Part I.C. (discussing the duty of loyalty as the only remaining fiduciary obligation).

49. Cooter & Freedman, *supra* note 3, at 1067.

C. Duty of Loyalty

The lone fiduciary obligation that retains vitality is the duty of loyalty.[50] Corporate officers and directors must not engage in self-dealing with the corporation and may not be motivated by self–interest in their work for the corporation.[51] Activity that would otherwise constitute a breach of the duty of loyalty can be cured or ratified by approval from a majority of disinterested directors[52] or a majority of disinterested shareholders.[53] Without such approval, a director can still avoid personal liability for conflicts of interest or self–dealing if he can prove that the action was fair to the corporation.[54] Most breaches of the duty of loyalty are ratified, and those that actually lead to liability are very specific and narrow in scope.[55] Courts tolerate all kinds of self–interested behavior by directors who use their position for personal, though non-monetary, advantage.[56] Such advantages are unavoidable and may serve in some instances to align managerial interests with those of the firm. Liability for breach of the duty of loyalty applies only to very narrow circumstances and circumstances that could be carefully and specifically defined and addressed in other ways.

If the duty of loyalty is really only a way to say "don't steal" from the corporation or "don't be conflicted," that is, do not use your position to make an unfair, personal profit at the corporation's expense, that seems a sufficiently specific command not to warrant the use of the broad, amorphous principle of fiduciary obligation. If we can define the kind of behavior we do not want the fiduciary to engage in, we can find ways to prohibit it without using a catch-all doctrine like fiduciary duty. Granted, we may not be able to describe specifically every potential breach, but parties to contractual relationships contract for and enforce standards all the time. The corporate duty of loyalty has become narrow enough that it is a standard that could be agreed to and enforced contractually. Fiduciary duties are intended to provide for circumstances we cannot predict, contractual terms for which we could not possibly anticipate the need. In some ways, they allow us to say to a fiduciary ex post, "You should not have done that. That was not consistent with our trust in you." Rather than so using fiduciary duties, Delaware courts have been *very* hesitant to extend fiduciary liability in unpredictable ways because they are afraid of

50. *See* Blair & Stout, *supra* note 24, at 299 (arguing that though the duty of loyalty imposes "important substantive limits on directors' behavior," this duty applies only to a narrow number of possible ways that corporate directors may abuse their power for personal gain).

51. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16 (2008); *see also* Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness. Specifically, directors cannot stand on both sides of the transaction nor derive any personal benefit through self-dealing.").

52. DEL. CODE ANN. tit. 8, § 144(a)(1) (2008).

53. § 144(a)(2). The disinterested requirement has been read in by courts. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976).

54. § 144(a)(3).

55. *See* Blair & Stout, *supra* note 24, at 299.

56. *Id.* ("[T]he duty of loyalty does not apply in circumstances where directors make strategic business decisions that provide nonmonetary benefits to themselves at shareholders expense. . . . Thus directors do not breach their duty of loyalty when they use firm funds to build a lavish headquarters, or to make donations to their favorite charities." (emphasis omitted)).

startling directors with unexpected liability.[57] As a result, the conflicts of interest for which Delaware courts will provide personal liability are clearly defined in the case law. As an example of what can happen when concern over the potential consequences of unexpected liability goes too far, consider what has become of liability for breaches of the duty of care and how that has resulted in significant limitation of the duty itself.

D. "Duty" of Care

There is some debate about whether the duty of care is a fiduciary obligation at all. When the fiduciary duties are listed, it is traditionally included.[58] However, many scholars have questioned this characterization of the duty of care.[59] Some argue that it is not fiduciary in nature because fiduciary relationships have no particular or exclusive claim on the obligation to act with due care.[60] The duty to act with the "minimum standard of skill, judgment, competence" is not necessarily fiduciary and is found in many non-fiduciary relationships.[61] While the duty of care may describe the behavior we want fiduciaries to exhibit, it is not a duty or obligation related particularly to fiduciary status. So, again, fiduciary duties are not necessary to order the relationship between corporate managers and the firm. Even though it appears there is nothing particularly fiduciary about the duty of care, this Part will consider what corporate law wants to accomplish with a duty of care, what is left of the duty of care now, and how the desired ends may still be achieved without the use of the fiduciary paradigm.

The corporate "duty of care" is hardly a duty to act with anything like particular "skill, judgment, or competence."[62] Incompetent managers with bad judgment are not subject to personal liability for their failings.[63] There are strong policy reasons for this choice. Delaware courts do not want to discourage profitable risk taking or keep worthy candidates from becoming corporate directors for fear that they will be personally

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57. William T. Quillen, *The Federal-State Corporate Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 118–19 (1993); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1454 (1985).

58. *See, e.g.*, Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1196, 1206 (2003); Blair & Stout, *supra* note 24 at 298; Skeen v. Jo-Ann Stores Inc., 750 A.2d 1170, 1172 (Del. 2000); *In re* Abbott Lab. Derivative S'holders Litig., 325 F.3d 795, 808 (2007).

59. *See, e.g.*, Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929, 961 (2008) ("The lack of due care is a wrong of a different nature than disloyalty because it is not intentional."); Ribstein, *supra* note 2, at 220 ("[A] duty of care should not be regarded as fiduciary in nature."); William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 183 (2005) ("To describe negligent acts as being breaches of fiduciary duty is misleading . . . ."); DeMott, *supra* note 8, at 915 ("Corporate directors . . . who surely occupy a fiduciary office, also owe the corporation a duty of care . . . That duty, however, is not distinctively fiduciary.").

60. SHEPHERD, *supra* note 10, at 49; Ribstein, *supra* note 2, at 220–21.

61. SHEPHERD, *supra* note 10, at 49. Shepherd goes on to say that "[i]n the instances in which fiduciary relationships have a duty of care attached, we posit that that duty of care rests either in contract (e.g. most agents) or in tort (e.g. some types of advisors)." *Id.*

62. *Id.* (describing the standard of care to which most fiduciaries are held).

63. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (holding that, despite the board approving a no fault termination resulting in the payment of a $130 million severance package, directors bore no personal liability because of the absolute strength of the business judgment rule); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (holding that despite dividend payment that harmed stockholders' interests, the business judgment rule protected the decisions, since there was no self dealing).

bankrupted on account of business decisions that are deemed unsuccessful with the benefit of hindsight.[64] Rather, the standard is a procedural one.[65] In order to fulfill the "duty of care" directors must only be sure to inform themselves regarding business decisions they make on the corporation's behalf and must exercise the most rudimentary monitoring of the corporate enterprise—that is, they must put in place a reporting structure that would allow them to find out about significant problems. They must observe proper and complete procedures in their management of the firm.[66] There is no obligation to do a good or competent job and no obligation to meet specified standards of excellence or judgment. "Honest" or "rational" is the standard by which a director's belief that he is acting in the best interests of the corporation is measured,[67] and mere negligence is certainly no grounds for a cause of action.[68]

The business judgment rule stands as the greatest obstacle for holding corporate officers and directors personally liable for failures in decision making. Courts will not review a board's business decisions as long as they were made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[69] It blocks many, if not all, attempts to hold directors liable for bad business decisions and so serves as the hurdle between possible breaches of the duty of care and liability. Further, the Delaware corporation statute allows directors, but not officers, to opt out of personal liability for breaches of the duty of care.[70] Officers and directors must be punished for incompetence in other ways.

Because the fiduciary structure has been eliminated as a way to reduce the costs caused by insufficient care, the market has devised alternative ways to monitor. For instance, creditor contracts have included covenants that say more about standards of

64. S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 95 (1979) ("[T]he fundamental premises underlying the business judgment rule . . . are simply that, as human beings, directors are not infallible. The first premise recognizes human nature, the second the need to foster both business and judicial economy by not allowing every corporate transaction to be subject to judicial review at the request of a disagreeing stockholder.").

65. *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.").

66. Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Courts do not measure, weigh or qualify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only.").

67. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in *good faith* and in the *honest belief* that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (emphases added).

68. BALOTTI & FINKELSTEIN, *supra* note 51, § 4.15 ("[T]he courts have now settled on *gross* negligence as the standard in the decision-making context. Gross negligence involves 'reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.'" (emphasis added)); *see also* Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del. Ch. 2005) ("Director liability for breaching the duty or care is 'predicated upon concepts of gross negligence.'" (quoting *Aronson*, 473 A.2d at 812)).

69. *Aronson*, 473 A.2d at 812.

70. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008). The provision's phrasing makes the duty of care the only "fiduciary" duty for which directors can avoid personal monetary liability.

officer and director conduct[71] than that which shareholders have been able to enforce according to the powers granted them in corporate statutes or corporate fiduciary litigation. Creditors rely on covenants to monitor managerial decision making without the aid of fiduciary duties.[72] These creditors go beyond specific rules about how managers are to ensure the repayment of corporate debt. The covenants outline standards of corporate governance as well.[73] If creditors can do it, then shareholders should also be able to contractually enforce such standards. This suggestion will be pursued in more detail below.[74] Next, this Part will consider how Delaware has sought to address the perception that there is no remedy under Delaware fiduciary law for incompetent or careless management.[75]

E. Good Faith?

With the duty of care de-fanged under Delaware corporate law, courts have sought to revive it or find another way to discipline managers for failing to perform their duties conscientiously.[76] Directorial duties may not command a director's full attention because a position on a board is only a part time job and directors usually have very demanding careers.[77] Too often the board is seen as a rubber stamp for executive officers or as deferring strongly to their expertise and judgment.[78] Consequently, the board could easily be considered asleep at the switch when corporate catastrophe occurs to their apparent surprise.[79] Such problems are typically addressed as duty of care violations, but recently

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71. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1212 (2006) ("Loan covenants now are the principal mechanism for handling one of the most challenging problems in corporate governance, the one that arises when a once-effective manager needs replacing and the operations of the business must go through a fundamental overhaul.").

72. Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009).

73. *Id.*

74. *See infra* Part III.B.

75. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 983 (2003) ("The gap between what Delaware law requires and what constitutes good corporate governance is enormous.").

76. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 93 (arguing that, since the sole reason for fiduciary duties is to maximize wealth, the goals of fiduciary law are not furthered by using fiduciary duties to justify expensive "direct monitoring" of boards of directors). Whether or not such monitoring is profitable or appropriate is not an argument this Article seeks to make. Rather, this Article demonstrates that, to the extent that we hold managers accountable in some way, though not necessarily through liability, for performing in a reasonably competent manner to the extent they are able is a goal of the law of corporate governance, fiduciary duties do not achieve that end.

77. *See* Elizabeth Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 445 (2007) ("It would be naïve to think that directors, when forced to choose how they prioritize their time and resources, always put their corporate charges at the top of their list, given the lack of penalties for not fully prioritizing the corporation.").

78. DEL. CODE ANN. tit. 8, § 141(e) (2008) fully protects corporate officers and directors from liability for

> relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

courts have sought to re-categorize them as failures to act in good faith.

Considering perhaps one of the most ill-advised corporate decisions in recent memory, in *In re Walt Disney Co. Derivative Litigation* the Delaware Supreme Court warned that good faith is available in very limited circumstances to hold directors accountable for failing to take actions consistent with the job they agreed to do for the corporation.[80] Disney's directors approved an employment agreement for Michael Ovitz to become president of the company for a term of five years.[81] The agreement provided that Ovitz could receive approximately $130 million in cash and stock options if he was terminated without cause before the end of the five-year term.[82] When the relationship soured after about 14 months, Disney granted Ovitz a no-cause termination and paid him $140 million.[83] Angry shareholders sued, certain that some remedy would be available to the corporation for a board's decision to compensate an executive with $130 million for doing an indifferent job for 14 months.[84] The court found no grounds for liability.[85] The board did not labor under a conflict of interest or engage in self-dealing,[86] it was fully informed as to the matters before it,[87] and most importantly, did not violate its duty to act in good faith.[88] The court recognized the distinction between the duty of care and the requirement that directors act in good faith, but endorsed a definition of bad faith that included a sort of "breach of the duty of care" *plus*.[89] That is, a director violates his duty to act in good faith when he "fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[90] That contemplates something between malicious intent to harm the corporation and the simple gross negligence encompassed by the duty of care.[91] Such a failure to act in good faith is a wrong not exculpated under section

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79. *See, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009) (holding that Citigroup officers and board members did not adequately understand the riskiness of the investments that constituted a large part of the company's profit, and caused its eventual collapse); Stone v. Ritter, No. Civ. A. 1570-N, 2006 WL 302558 (Del. Ch. Jan. 26, 2006) (dismissing shareholders' complaint because there was no proof that the board knew of the inadequacy of the corporation's internal controls); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (approving a settlement agreement for violation of federal insurance law that imposed no personal liability for directors when the directors did not intentionally disobey the law and had no specific reason to believe that their monitoring program was inadequate to prevent illegality).

80. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64–66 (Del. 2006).

81. *Id.* at 34.

82. *Id.*

83. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 278–79 (Del. Ch. 2003).

84. *In re Walt Disney Co.*, 906 A.2d 27.

85. *Id.* at 35–36.

86. *Id.* at 52–53.

87. *Id.* at 60–61.

88. *Id.* at 62–65. The court stated that "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith." *In re Walt Disney Co.*, 906 A.2d at 65.

89. *Id.* at 68.

90. *Id.* at 67.

91. *Id.* Nowicki discusses the legal distinction between a "bad faith" standard and a "not in good faith" standard for evaluating the actions of directors. Nowicki, *supra* note 77, at 443–44. Essentially, the standard has flipped, and now requires directors only to refrain from affirmatively bad acts; such a standard creates little motivation for directors to maintain a high degree of action or oversight since such inattentiveness rarely, if ever, leads to liability. *Id.*

102(b)(7).[92] This reasoning provides a path to liability for a dereliction of duty and extreme carelessness without resort to a duty of care.

The Delaware Supreme Court made the connection between egregious care violations and bad faith even more clear in *Stone v. Ritter*.[93] Without finding grounds for liability, the court explained that egregious violations of the duty of care could constitute violations of the obligation to act in good faith which, in turn, could be considered violations of the duty of loyalty.[94] The case involved an alleged violation of the duty to monitor, which requires that directors implement reporting or information systems designed to make them aware of possible violations of law or activities that may subject the corporation to liability.[95] That obligation to monitor is a component of the duty of care in that it is part of the board's duty to remain informed of major corporate activities and to oversee the corporation and its management.[96] In *Lyondell Chemical Co. v. Ryan*, the Delaware Supreme Court took some of the wind out of the sails of this new basis of liability by emphasizing that such breaches of the duty of care would be difficult to prove, requiring plaintiffs to show that directors "utterly failed" in their duties, agreeing with the Chancery Court's holding in a different case that an "extreme set of facts" would be required to find a breach of the duty of loyalty via dereliction of duty.[97]

If we can define a failure to fulfill management responsibilities as a violation of the duty of loyalty, then we have effectively expanded the one truly fiduciary duty to cover everything.[98] The Delaware Supreme Court has been cautious to open the duty of loyalty door that far and therefore sets the good faith bar very low.[99] It seems that the Delaware Supreme Court knows it wants to capture more bad behavior by directors than it currently can, but it doesn't want to relax liability rules too much.[100]

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92. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

93. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

94. *Id.* at 370. The court stated, "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.*

95. *Id.* at 369–70.

96. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (explaining that the duty derives from authority given to boards of directors in tit. 8, § 141(a) of the Delaware Code).

97. Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009) (citing *In re* Lear Corp. S'holder Litig., 967 A.2d 640 (Del. Ch. 2008)).

98. *See* Andrew Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. (forthcoming 2009) (arguing that these loyalty cases greatly expand the duty of loyalty beyond a duty not to engage in self-dealing or financial conflict and serve an important expressive function even though they are not likely to lead to increased liability).

99. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006):

> [T]he concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

Id.

100. E. Norman Veasey, *Corporate Governance and Ethics in a Post Enron/Worldcom Environment*, 72 U. CIN. L. REV. 731, 734 (2003) ("There must . . . be a balancing of director accountability with the need to encourage qualified, conscientious and honest people to serve as corporate directors."); Stone *ex rel.* AmSouth

When Delaware courts do use the flexible nature of fiduciary duties to hold directors liable unpredictably, the reaction is swift and negative. Commentators sound warnings that qualified professionals will refuse to become directors.[101] So courts tread carefully now, warning in advance that certain behavior will not be tolerated, that there are limits to the courts' permissiveness,[102] but such warnings are dicta. It seems that the remedy we have devised for breach of duty—personal liability for directors—is one with which we are not comfortable. Perhaps it is too extreme and, so, because the remedy for breach of fiduciary duty seems too severe, we deny the duty any enforcement; we remove its teeth.[103] By refusing to find breaches of fiduciary duty where we have not before, we lose the theory's strongest advantage—as flexible, loosely defined obligations available to provide liability for unpredictable disloyal conduct. If we were to suspect ex ante that a fiduciary would behave so disloyally, we would have specifically told him not to. Instead, the approach has been to suppose that if we have not specifically told the fiduciary not to behave in the manner in question, we cannot provide liability for his doing so now. With that reasoning, we may never have developed the fiduciary duties we are comfortable enforcing now (the duty to abstain from self-dealing or usurping corporate opportunities), and we will never allow fiduciary obligation to grow and change with the times.

My argument is not that nothing is lost with the death of corporate fiduciary duties. Indeed, we may get quite a bit of mileage out of officers and directors believing that they do owe fiduciary duties, even if the legal doctrine does not actually impose such a strong standard.[104] While I may be able to demonstrate that corporate fiduciary duties have lost their prominence in corporate law, the question of whether or not that is a good thing is another one entirely. The flexibility fiduciary duties provide can be very useful, but the current state of corporate law refuses to use fiduciary duties flexibly and so, in an attempt to make fiduciary duties predictable, the law has robbed them of their greatest potential strength and rendered the limited purpose they achieve more easily and directly achievable through other means. That change may prove beneficial and a far more effective way to discipline corporate managers.

All of this is complicated by the fact that even meritorious litigation against corporate managers for breach of fiduciary duty fights an uphill battle wholly apart from

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Bancorporation v. Ritter, 911 A.2d 362, 372 (Del. 2006) ("[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board services by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors." (quoting *In re Caremark*, 698 A.2d at 971)). This reasoning may present a moral hazard problem in that qualified people who balk at accepting seats on corporate boards only when assured that the chances of liability are low may be people who would incur liability were the tests less demanding and may indeed be likely to march right up to the line where liability starts. It is fairly widely accepted that good governance practices end far before liability begins. *In re Walt Disney Co.*, 907 A.2d at 697.

101. Quillen, *supra* note 57, at 118–19 ("*Van Gorkom* also had the negative effect of discouraging qualified outsiders from serving on corporate boards as independent directors . . . ."); Fischel, *supra* note 57, at 1454 ("[Directors] will be less willing to serve (the best protection against getting sued), and when they do serve, will overinvest in information and be less entrepreneurial.").

102. *See, e.g.*, *Stone*, 911 A.2d 362 (illustrating the limits to the courts' permissiveness).

103. This results from the idea expressed in the maxim *ubi jus, ibi remedium* ("where there is a right, there is a remedy"). *See* Ashby v. White, (1703) 92 Eng. Rep. 126, 136 (K.B.) (Holt, C.J., dissenting) ("[I]ndeed it is a vain thing to imagine a right without a remedy; for . . . want of right and want of remedy are reciprocal . . . [w]here a man has but one remedy to come at his right, if he loses that he loses his right.").

104. Gold, *supra* note 98.

the stringent liability tests.[105] Between the tangled and difficult demand process,[106] the likelihood of relatively meaningless settlement, and the strict rules disfavoring liability in the courts, shareholders are unlikely to get very far with a suit alleging breach of fiduciary duty by management.[107] The current system relies on a clumsy combination of smoke and mirrors to discourage bad behavior through stern threats of possible liability while only punishing truly egregious behavior, often ineffectively and after it is too late.[108] Personal liability rules may not be the best way to discipline management.[109] If a right is only as great as its remedy, the right to hold corporate managers liable as fiduciaries is not very great. Perhaps some kinds of liability rules would be effective, but trying to fit the square peg of managerial responsibility into the round hole of fiduciary doctrine causes problems. Indeed, these acrobatics are unnecessary, confusing, and lead to the assumption that fiduciary liability is all state corporate law has to offer.[110] Fiduciary liability is simply not the best way, and may be the worst way, to achieve what we want to achieve in corporate governance: the effective monitoring and discipline of corporate managers who exercise independent business judgment in the corporation's affairs. We certainly want some way to discipline managers, and a good deal of what fiduciary duties have to offer makes intuitive sense in the corporate context. It turns out, though, that over time, Delaware courts have revealed that application of fiduciary principles causes more harm than good and that other mechanisms may discipline managers in more palatable and predictable ways.

F. Summary

The duties Delaware claims to enforce are narrow and not even necessarily fiduciary in nature. The corporate fiduciary law struggles with how to apply fiduciary standards to the behavior of corporate management and, in the end, squanders that opportunity. This Part has explained how corporate fiduciary duties are currently defined and has begun to question the extent to which they conform to traditional notions of fiduciary obligation. The next Part will consider the purposes served by using fiduciary obligation as a monitoring and disciplinary device and will determine whether corporate fiduciary duties qualify as fiduciary relationships in light of the way they are used.

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105. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271 (1986).

106. *See* Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 175–77 (arguing that despite the rationale of claims that the shareholder demand process supports judicial efficiency, the practical effect is that since board members rarely grant demand, shareholders who file suit claim that demand would be futile, leaving the courts still ultimately responsible for dealing in derivative claims).

107. Fischel & Bradley, *supra* note 105, at 271.

108. *See* Elizabeth A. Nowicki, *A Director's Good Faith*, 55 BUFF. L. REV. 457, 475–77 (2007) (describing the many statutory and evidentiary hurdles that shareholders face in bringing suit against directors).

109. Fischel & Bradley, *supra* note 105, at 271.

110. *See* Gold, *supra* note 98 (explaining the Delaware courts' attempts to describe more activities as breaches of the duty of loyalty in an attempt to create social norms that will encourage appropriate behavior by corporate officers and directors). The "new" loyalty breaches Gold isolates constitute actions that are already forbidden by other laws. *Id.* It is hard to see what fiduciary obligation has to add other than a voice for state law in a relatively crowded law market banning corporate fraud and white-collar crime.

III. APPLYING THEORIES OF FIDUCIARY DUTIES AND FIDUCIARY RELATIONSHIPS

Fiduciary relationships are necessarily amorphous. Most of the fiduciary duty scholarship has perused the cases to distill a definition, rather than formulating a definition before checking to see if the court decisions conform.[111] While this may be a worthy approach, particularly if one is exploring the state of the positive law, it makes it difficult to develop a purely theoretical notion of fiduciary obligation. A relationship is considered "fiduciary" simply because a court says it is. We are left without a framework to use to criticize the decisions. Because this Article is interested in determining whether a relationship that courts routinely assume warrants fiduciary status is, in fact, fiduciary, it will not focus on the granting of fiduciary status or on definitions of fiduciary relationships. Instead, it will inquire behind those opinions and theoretical definitions to find the purpose of fiduciary relationships. It will then compare the current application of fiduciary duties in corporate law to the dominant purposes for their use.

The classes of fiduciary relationships differ from each other. While some may try to draw analogies between the types, each kind of relationship and the attendant duties must conform to the particular needs of the relationship at issue.[112] For instance, agents and trustees are both fiduciaries, but face different fiduciary duties and expectations.[113] Corporate officers and directors may stand in fiduciary relation to the corporation, but their duties have never been perfectly analogized to either agents or trustees. In order to figure out whether corporate managers bear a fiduciary relation to the corporation, we must first determine why the relationship needs to be fiduciary. What is it about the relationship or the job officers and directors are to do that makes fiduciary obligation and jurisprudence a necessary tool for protecting the relevant parties' interests? After addressing that point, this Part will consider whether courts' enforcement of corporate fiduciary duties and corporate constituents' use of fiduciary duties comports with the purposes fiduciary duties are intended to serve in the corporate context. Because fiduciary obligations are gap fillers and catch-alls and are, above all, rooted in equity, their enforcement eschews specific and strict legal definition.[114] Therefore, any determination about their role or existence must focus on what it is that the imposition of fiduciary obligation is intended to achieve.

This Part will explore three common theories of the proper role of fiduciary duty analysis in corporate law.[115] First, the reliance theory supposes that fiduciary duties are rooted in moral obligations to behave in a trustworthy manner when placed in a position

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111. *See, e.g.*, Deborah DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 936–38 (2006) (criticizing the definitions she gleans from court opinions); SHEPHERD, *supra* note 10, at 45–50; Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 429 (noting that although courts do not "*talk* like Ronald Coase," an examination of the decisions they reach can reveal a consistent theory that explains those decisions).

112. Sara L. Broyhill, *Death of a Remedy: The Supreme Court's Ill-Fated Decision to Foreclose an Avenue of Liability Against Managed Care Organizations Under ERISA in* Pegram v. Hendrick, 79 NEB. L. REV. 762, 780 (2000).

113. FRANKEL, *supra* note 4, at 27–29.

114. SHEPHERD, *supra* note 10, at 3–4.

115. There are other theories, such as that devised by Gordon Smith in *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002). I focus on the three most widely held theories for the purposes of this Article.

of trust and confidence upon which others rely (reliance theory).[116] Second, fiduciary duties in corporate law reduce the agency costs incurred as a result of placing control over corporate assets and decisions in the hands of managers who do not own the firm (agency theory).[117] Third, fiduciary duties are intended to strike the bargain the parties would have agreed to had they negotiated about a particular problem in advance.[118] Because parties to a contract cannot plan in advance for every contingency, fiduciary duties allow courts to enforce a "hypothetical" bargain (contractarian theory).[119] It is through understanding those phases of fiduciary relationships that we appreciate how corporate law no longer relies on fiduciary duties to monitor and constrain the behavior of officers and directors.

A. Evolving Away from Corporate Fiduciary Duties

There is no question that the relationship of corporate officers and directors to the firm is one that would satisfy most definitions of a fiduciary relationship. Corporate managers indeed acquire power "on condition that [they] also receive with it a duty to utilize that power in the best interests of another . . . ."[120] Corporate investors must trust those who operate the business because the investors' capital is at stake.[121] The relationship between the corporation's officers and directors and the many constituencies that compose the firm is one in which the managers are given the power to control the use of the firm's assets for the sole purpose of maximizing combined value.[122] A director is not to work on his own behalf, but on behalf of and in the interest of maximizing the corporation's wealth. Because significant power is entrusted to the manager over the means by which he achieves the designated ends, and because there is, theoretically, significant potential for a faithless or dishonest manager to abuse that power for the advancement of his own self-interest, corporate governance relationships are naturally categorized as fiduciary.[123]

A relationship originally conceived as fiduciary may grow, in time, to lose that fiduciary character. That is, it may cease to be a relationship in which the one who is relying on a surrogate assumes she can trust the fiduciary and depend on that trust to assure the success of the entrusted enterprise. The party who began as the "entrustor" relies on other methods to protect her from the potential abuse of the fiduciary's power. Parties often enter into an agreement in which one promises to perform a task on behalf of the other, and to do it well, and then expect the precise terms of the agreement and remedies provided by law, rather than equitable concepts of trust, to protect their

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116. SHEPHERD, *supra* note 10, at 56.

117. Frankel, *supra* note 5, at 808; Ribstein, *supra* note 2, at 217; SHEPHERD, *supra* note 10, at 96.

118. Easterbook & Fischel, *Fiduciary Duty*, *supra* note 3, at 431.

119. *Id.*

120. SHEPHERD, *supra* note 10, at 96.

121. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 41–42 (2008).

122. SHEPHERD, *supra* note 10, at 83 (describing Weinrib's "Power and Discretion Theory" which states that a fiduciary relationship exists where "there is a relation in which the principal's interests can be affected by, and are therefore dependent on, the manner in which the fiduciary uses the discretion which has been delegated to him. The fiduciary obligation is the law's blunt tool for the control of this discretion." (quoting E.J. Weinrib, *The Fiduciary Obligation*, 23 U. TORONTO L.J. 1 (1975))).

123. Frankel, *supra* note 5, at 808–11.

interests. Such relationships are regarded as contractual rather than fiduciary. Of course, all fiduciary relationships are contractual in some way. The relationship is consensual: the fiduciary agrees to assume a position relative to a beneficiary with regard to a particular matter via contract. Indeed, the line separating the two relationships can blur at times and categorizing corporate relationships as either contractual or fiduciary is problematic.[124] Some scholars argue that corporate governance combines elements of contract and fiduciary law.[125] That is, the fiduciary law is used to fill gaps in contracts that could not possibly provide for every possible contingency.[126] Others, mostly in the context of unincorporated business associations, maintain that the contractual obligation to perform in good faith and to engage in fair dealing can serve some of the same purposes as fiduciary duties without making the relationship fiduciary.[127] Still, a distinction must be drawn between relations governed entirely by contract terms and those that impose, and are supplemented by, fiduciary obligation. Corporate law is moving closer to non-fiduciary contractual relationships.

B. Reliance Theory

Fiduciary relationships, those based on trust and confidence, can be construed as proceeding from moral premises.[128] Corporate fiduciary duties are no exception. Professor David Bayne asserted that:

> The contrôleur, then, is the topmost person in the corporate hierarchy. In this all-important contrôleur resides the final corporate destiny. Here, therefore, is the center of corporate morality. Or immorality. If the movement toward a sophisticated corporate mores is to progress apace, it must begin with, and branch out from, an exact delineation of the fiduciary duties of the contrôleur. As the contrôleur carries himself, so will the corporation prosper. If the contrôleur is rotten at the center, the whole corporate barrel will decay.[129]

Bayne focused, then, on the moral standing of the person, or entity, in control of the corporation and considered that position to be defined by the necessity for trust and moral integrity.[130] Professor J.C. Shepherd described the reliance theory for defining fiduciary relationships as "the most basic" fiduciary theory and one that finds its roots in "an ethical or moral imperative."[131] This reliance on moral theory of fiduciary obligation holds that a "fiduciary relationship exists where one person reposes trust, confidence or

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124. *See* Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV 1315, 1349–50 (2008) (describing the co-existence of fiduciary and contractual relationships in a corporation); Brudney, *Contract and Fiduciary Duty*, *supra* note 8, at 622–29 (same); Scott FitzGibbon, *Fiduciary Relationships are Not Contracts*, 82 MARQ. L. REV. 303, 316–20 (1999) (same).

125. *E.g.*, Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 427.

126. *Id.*

127. Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 134–40 (2006).

128. *See* BAYNE, *supra* note 8, at 23–24 (describing the custodial duty of a fiduciary); SHEPHERD, *supra* note 10, at 56 (describing the "reliance theory" of fiduciary obligation).

129. BAYNE, *supra* note 8, at 6.

130. *Id.*

131. SHEPHERD, *supra* note 10, at 56–57.

reliance in another."[132] In such a situation, the expectation is that the fiduciary will not abuse the trust reposed in him. Equity stands ready to enforce this moral obligation[133] for the protection of the beneficiary and society as a whole, as both need to be able to rely on fiduciaries and trust those with the ability and judgment to act for their benefit.[134]

Regardless of the merit of this "moral" theory as a useful conception of fiduciary relationships or a statement of the purpose of their enforcement, courts have been quick to adopt it when describing the virtues of enforcing corporate fiduciary duties. For example, in *Guth v. Loft Inc.*, the Delaware Supreme Court opined:

> A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[135]

Guth v. Loft Inc. is the seminal case declaring the usurpation of a corporate opportunity to be a breach of the duty of loyalty. Other courts have appealed to a moral basis for the duty of loyalty in other circumstances.[136]

Characterizing the corporate fiduciary relationship as one relying on notions of trust does not describe the current landscape of corporate law or policy. The *Guth v. Loft* court's colorful description of corporate fiduciary obligation does not describe the current corporate governance climate or the law shaping it. Rather than expecting corporate officers and directors to be trustworthy and act in the corporation's best interests, the market, creditors, shareholders, and federal regulators have been motivated by the assumption that corporate managers cannot be trusted. The problem has not arisen because Delaware courts have given up on fiduciary duties; rather, Delaware courts do

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132. *Id.* at 56.

133. I do not express an opinion about whether directors have purely moral obligations to behave loyally toward the corporation or its shareholders, though I believe that a strong argument could be made that they do. This Article focuses on fiduciary relationships as creatures of law and so is concerned with whether there is a legally enforceable (or enforced) obligation that is fiduciary in nature. Non-legal duties are beyond the scope of this Article. I mention moral obligation here only to illustrate that some theorists argue that the moral obligation to behave in a trustworthy and loyal manner gives rise to the legally enforceable fiduciary obligation.

134. SHEPHERD, *supra* note 10, at 57; *see* Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 313–15 (1999) (discussing the equitable nature of fiduciary duties and potential equitable remedies upon breaches of fiduciary duties that may be available to corporate bondholders).

135. Guth v. Loft Inc., 5 A.2d 503, 510 (Del. 1939).

136. For example, in considering insider trading liability under federal securities laws, the United States Supreme Court justified the connection between trading on inside information and the outlawed fraud in connection with the purchase or sale of a security. The Court reasoned that a "deceptive device" exists when a corporate insider trades "'on the basis of material, nonpublic information'" because of the "'relationship of trust and confidence [existing] between the shareholders of a corporation and those insiders'" that forbids officers and directors from "'taking unfair advantage of . . . uninformed . . . stockholders.'" United States v. O'Hagan, 521 U.S. 642, 652 (1997) (quoting Chiarella v. United States, 445 U.S. 222, 228–29 (1980)).

not enforce fiduciary duties. So, those duties cease to exist. While Delaware courts have rested on the assumption that the corporate fiduciary doctrine is rigorous enough to discipline managers adequately, other forms of monitoring have been adopted to fill in the gaps left by Delaware law. Because these other monitoring efforts have been effective, corporate constituents rely less heavily on fiduciary duties, thus rendering them more and more obsolete.[137]

The other monitoring devices include strict disclosure requirements for publicly traded companies,[138] increased use of securities regulations to discipline corporate managers,[139] use of demanding loan covenants,[140] and equity compensation to try to align managerial personal interest with corporate wealth maximization.[141] This Article will consider each of those devices below. For now, the important point is that if we look at how the market of corporate investors has addressed the problem of monitoring and disciplining management, we see that those investors do not trust corporate officers and directors at all. When devising ways to reduce the agency costs inherent in the separation of ownership, however defined and by whatever parties, and control, investors assume that managers will act in their own self interest whenever possible and have invented ways to discover and manipulate managerial self interest. They have increased their monitoring of managerial behavior and decision making by enhancing disclosure requirements—both by contract and through regulation.[142]

Professor Tamar Frankel asserts that a fiduciary relationship exists if, among other things, "[t]he markets or other private sector parties fail to protect entrustors from the risks posed by fiduciary relationships."[143] Where, as in the corporate governance market, the relevant parties are doing more and more to protect the entrustors—here, the investors—from risks associated with having to trust corporate management, the fiduciary nature of the relationship atrophies. While the nature of that trust, or the necessity for it, may be a basis for the finding of a fiduciary relationship and would justify the application of fiduciary duties, the "risks" associated with that trust are commonly referred to as agency costs.[144] Reducing the effects of those risks is another commonly cited and important purpose for the imposition and enforcement of fiduciary duties.[145]

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137. Fischel & Bradley, *supra* note 105, at 267–68.

138. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7201–66 (2006) and in scattered sections of 15 U.S.C., 18 U.S.C., 28 U.S.C., & 29 U.S.C.).

139. David E. Brown, Jr. & Michael P. Reed, *Enron and Worldcom Settlements Reflect Need to Reexamine Director Liability Standards*, 20 LEGAL BACKGROUNDER 1 (2005), *available at* http://www.wlf.org/upload/042205LBBrown.pdf.

140. Baird & Rasmussen, *supra* note 71, at 1212.

141. M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 NW. U. L. REV. 1543, 1544 (2007).

142. It is expensive to invest in both monitoring and fiduciary duty enforcement. It is better to commit to one than split investment between the two.

143. FRANKEL, *supra* note 4, at 65.

144. *Id.*

145. *Id.*

C. Agency Costs

The perception that fiduciary duties exist for the purpose of minimizing agency costs associated with the delegation of power over one person or entity's well-being to another is pervasive and expressed in a number of different, but related, theories about the role and purposes of fiduciary obligation.[146] According to agency cost theories, the purpose of fiduciary duties is to preserve the efficiency gained by delegating powers to someone more qualified.[147] Fiduciary relationships produce efficiencies by allowing those with experience—fiduciaries—to act on behalf of the beneficiary so that the beneficiary may devote its resources to the pursuits to which it is best suited.[148] This maximizes the wealth produced by society. If those who are entrusted with power may abuse it, the entrustors must devote time and energy to careful and constant monitoring which may limit their productivity, or may lead them to act on their own behalf rather than delegating control at all. Without such delegations of power, our economy and society would suffer.[149]

Fiduciary obligations are neither the only ways to regulate such delegations of power and control nor are they always the most effective means to do so.[150] While fiduciary duties can prove a useful means to minimize the costs associated with delegation of authority, or "agency costs," they are often expensive to enforce. Relationships between willing parties can be arranged in such a way as to render the fiduciary structure unnecessary.[151] This Part considers three views of the agency costs theory that approach it from subtly different angles. This Part then demonstrates that this justification cannot account for corporate law's reliance on fiduciary duties.

The agency costs theory is closely related to theories that justify fiduciary duties by reference to a delegation of power or authority. Delegation of authority would not warrant special duties unless it posed some sort of potential cost. "Agency cost" is the summary term used to define those costs, whatever they may be. Several commentators suggest variations on the agency costs theory of fiduciary obligation.[152] Shepherd argues

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146. "Agency costs" are found in the delegation of some authority to directors. They are asked to make decisions on behalf of the firm because the inanimate firm cannot do so itself. Further, the owners of the corporation, however defined, would rather appoint experienced business professionals to operate the firm than operate it themselves.

147. Frankel, *supra* note 5, at 803–04 (describing the social trends of specialization and pooling as economic benefits that lead to the delegation of power and, thereby, to the imposition of fiduciary duties).

148. *Id.*

149. *See id.*

150. Ribstein, *supra* note 2, at 213 ("Outside of the paradigm broad-delegation scenario, fiduciary duties may add little to other constraints on the agent's conduct."); Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 CARDOZO L. REV. 51, 61 (2000) ("[M]ore effective means than enforcement of fiduciary norms may exist for dealing with miscreant partners."); Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767, 773 (1989); Frankel, *supra* note 5, at 811 ("If the entrustor can protect himself from abuse of power, there is no need for the intervention of fiduciary law . . . . Therefore, the need for fiduciary law depends on the extent to which the entrustor can prevent the abuse of power through other legal or social means.").

151. Easterbrook and Fischel claim that "[a]gency is a necessary but not sufficient condition" of a fiduciary relationship and note that "[i]f it were sufficient, then all business relations would be fiduciary, and the category would lose its distinctive quality." Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 436.

152. Countless scholars have based their understanding of the purpose of fiduciary obligation in corporate law on the goal of reducing agency costs. *See, e.g.*, Ibrahim, *supra* note 59, at 931 ("Fiduciary duties are meant

that "[a] fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power."[153] Frankel bases her definition of fiduciary relationships on the possibility of abuse of the power that is delegated by one party to another[154] and states that a "substitution function and the delegation of power" are "[t]he two central characteristics of fiduciary relations."[155] Professor Larry Ribstein concludes that fiduciary duties are only necessary in business organizations where one party has been granted "open-ended control" over the affairs of another.[156] He uses this defining purpose of fiduciary relationships to make the case that partners are not fiduciaries of one another.[157] Similar reasoning can now be applied to the officers and directors of public corporations.

1. Acceptance of Position of Trust and Power

Shepherd would say that corporate officers and directors owe fiduciary duties because they take power over corporate decision making on the condition that they make business decisions that are in the best interests of the firm and its owners, not decisions that are in their own personal best interests at the expense of the maximization of the firm's wealth.[158] Corporate officers and directors are not to run the company for their own personal use or advantage; rather, they are expected to maximize the firm's value for the benefit of others. If managerial interest and corporate interest conflict, the manager is expected to prefer the corporation. This obligation to eschew self-interest in the performance of a task in favor of the best interests of another is what, Shepherd would argue, makes the corporate officer or director's relationship with the corporation fiduciary.[159]

While that conception of the corporate governance relationships was once accurate, it no longer describes the way officers' and directors' interests are aligned with those of the company. Corporate investors no longer trust managers to make interests other than their own paramount. As courts have protected the ability of officers and directors to pay themselves and each other exorbitant salaries,[160] deal for their own account with the

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to reduce agency costs between shareholders and directors."); DUKEMINIER ET. AL, WILLS, TRUSTS, AND ESTATES 775 (7th ed. 2005) ("Hence the fiduciary obligation in trust law is the primary tool for reducing agency costs."); *See* Fischel & Bradley, *supra* note 105, at 266 (discussing fiduciary obligations as a method of reducing agency costs in the context of the publicly-held corporation); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982) ("Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost.").

153. SHEPHERD, *supra* note 10, at 96.

154. Frankel, *supra* note 5, at 804.

155. *Id.* at 809.

156. Ribstein, *supra* note 2, at 217 ("[A] fiduciary duty is appropriate only where the owner delegates open-ended power to the manager. . . . Classic examples where the costs are justified include the relationship between management and dispersed owners in a traditional publicly held corporation . . . .").

157. *Id.*

158. SHEPHERD, *supra* note 10, at 35.

159. The precise party to whom fiduciary duties are owed in the corporate context is considered *supra* at Part I.B.

160. *See generally In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. Ch. 2006).

corporation,[161] and assign themselves extraordinarily lucrative, and sometimes even backdated, stock options,[162] the market and federal securities regulatory structure have stepped in to plug the holes left by Delaware fiduciary jurisprudence. The wane of fiduciary protections has not only changed the character of the corporate governance relationships, but it has also facilitated development of an environment of mistrust so that interested parties are forced to adopt monitoring and disciplinary mechanisms rather than rely on trust in officers and directors.

Corporations extensively compensate managers with equity in order to tie their best interests to the interests of the firm's bottom line. The assumption is that officers and directors will act in their own self-interest and are principally motivated by that interest. We rely more on reputation to constrain directors than on fiduciary liability; a reputation is easily sullied, while liability for breach of fiduciary duty is rare. We assume that managers will be guided by personal interest and seek to check the consequences of that self-interest through monitoring and equity compensation, and an active market for managerial talent, rather than relying on any sense of enforceable fiduciary obligation to operate the company for the benefit of an entrusting, though increasingly less clearly defined, beneficiary party.

2. Abuse of Power

Professor Frankel would say that corporate officers and directors owe fiduciary duties because they are granted control over extremely valuable assets in a way that allows them to abuse that power and appropriate those assets to their own benefit.[163] The fact that managers are charged with making business decisions so that the shareholders do not have to find a democratic way to make the decisions themselves does not make the relationship fiduciary. Instead, she would argue, it is the potential for abuse, the ability of corporate managers to abscond with company assets, to use their positions to cause the corporation to make decisions to enhance the officers' and directors' personal wealth while compromising that of the corporation, that renders fiduciary duties necessary to impose discipline on the managers and moderate the relationship.[164] Fiduciary duties would be unnecessary if other mechanisms were put in place to adequately protect against the threat of abuse of power.

161. *See* DEL. CODE ANN. tit. 8, § 144 (2008). With requisite approval from a majority of shareholders or a majority of disinterested directors, an officer or director may transact business with the corporation. This approval is not necessarily difficult to obtain, especially when it is requested of fellow directors. Further, once the self-dealing is thus "ratified" it is extremely difficult for suspicious shareholders to overturn because the decision to ratify the self-dealing transaction is afforded virtually impenetrable business judgment rule protection. This concept was explored further *supra* at Part I.C.

162. *In re* CNET Networks, Inc. S'holder Derivative Litig., 483 F. Supp. 2d 947 (N.D. Cal. 2007) (applying Delaware law).

163. Frankel, *supra* note 5, at 809 ("The two central characteristics of fiduciary relations—the substitution function and the delegation of power— . . . create[] a risk that he will misuse it . . . .").

164. *See* FRANKEL, *supra* note 4, at 21–23 (explaining the recent historical developments of corporate fiduciary duties).

a. Theft

While large, one-shot thefts from a corporation will always be possible for officers and directors given access to a company's confidential information and the power to direct the use of its funds, such crimes against the corporation are very well punished, and thereby deterred, without resort to fiduciary duties.[165] Again, if another way to address the threat exists, fiduciary duties are unnecessary and may be comparatively inefficient or ineffective. Criminal law and securities regulations are specifically designed to address these crimes. Theft is illegal even if committed by a corporate officer or director.

b. Insider Trading

Fiduciary duties have long been considered the basis for a prohibition of insider trading, both under state and federal law.[166] Corporate officers and directors must be entrusted with confidential corporate information in order to make good decisions on the firm's behalf. The best interests of the corporation often mandate that some important information about its business prospects or plans not be made public for a certain period of time. During that time, corporate insiders who must use the information in their service to the firm may be able to derive an advantage in buying or selling the corporation's stock on account of the non-public information they have. Typically, engaging in a purchase or sale of a good with information superior to the other party to the transaction does not present a case for legal liability. However, because corporate insiders, including officers and directors, hold confidential information "in trust" for the benefit of the corporation and its shareholders, they cannot simultaneously use that information for personal profit to the detriment of the individual shareholders with whom they transact or of the market as a whole.[167]

The United States Supreme Court has combined state fiduciary law and the federal securities law prohibition of fraud or deceit "in connection with the purchase or sale of any security" to create insider trading liability.[168] It is the breach of fiduciary duty that constitutes the fraud or deceit. This way, not all those who trade on material non-public information will be held liable for securities fraud.[169] Also, through that mechanism, the Supreme Court avoided overturning its decision in *Santa Fe Industries v. Green*, which held that federal securities laws were not to be used to enforce state fiduciary

165. Deterring or punishing this behavior is supposed to be a major function of fiduciary duties. Blair & Stout, *supra* note 24, at 315 ("[C]orporate law encourages directors to serve their firms' interests *by severely limiting their ability to serve their own.*").

166. *See* United States v. O'Hagan, 521 U.S. 642 (1997) (describing the "classical theory" of insider trading liability); *see also* Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933) (finding no violation of state insider trading laws where there was no breach of duty).

167. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 553, 518–609 (2002).

168. 17 C.F.R. § 240.10b-5(c) (2008); *see O'Hagan*, 521 U.S. 642.

169. For cases tying the trading of non-insiders to a breach of a fiduciary duty, see Chiarella v. United States, 445 U.S. 222 (1980), Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646 (1983), and *O'Hagan*, 521 U.S. 642, which established that an individual who either learns material inside information from someone with a fiduciary duty or breaches some fiduciary duty to the person who shared the information may be held liable. In this way, liability has grown to encompass those who are not corporate insiders in the event that someone's trust was knowingly breached by the trading.

principles.[170] The Court characterized the breach of fiduciary duty as a form of deceit and so, when connected to the purchase or sale of a security, it constituted a breach of Rule 10b-5. The Court was not providing a remedy for state law breach of fiduciary duty, but was rather policing a kind of securities fraud.[171] That reasoning demonstrates both an instance in which state law fiduciary duties are important as they apply to corporate insiders, such as officers and directors, and also an instance in which federal law is able to police the fiduciary breach better than could state courts.[172] In fact, at this point, state insider trading liability has all but died while the federal scheme dominates.

The fiduciary construct seemed necessary to the federal scheme. Without a breach of duty, federal law would apparently have nothing with which to satisfy the fraud or deceit requirement. However, the United States Supreme Court began to move away from the fiduciary link to insider trading with the *Chiarella*,[173] *Dirks*,[174] and *O'Hagan*[175] cases, in which the Court considered, and in some cases provided for, insider trading liability regardless of whether the trader owed a fiduciary duty to the corporation itself. Focus on *some* fiduciary duty, rather than one owed to the corporation, moved the federal insider trading jurisprudence away from state corporate fiduciary duty principles. Reliance on fiduciary duty has disappeared. Professor Donna Nagy points out that "numerous lower courts and the SEC have in effect concluded that the wrongful use of information constitutes the crux of the insider trading offense and that fiduciary principles are only relevant insofar as they establish such wrongful use."[176] A theory developed under federal law can prosecute insider trading without regard to fiduciary duties by focusing instead on any wrongful use of information.

This is a prime and important example of the corporate law's evolution away from fiduciary duties. Where a potential for abuse is identified, the market, and federal and criminal law, address that risk directly and specifically rather than relying on fiduciary principles to close the gap. Still, independent managerial decision making remains an important part of corporate governance, and minimizing the agency costs resulting from that independence, beyond outright abuse of power, is an important purpose of corporate fiduciary law. The next Part considers an agency cost theory of fiduciary obligation that focuses on the consequences of independent, open-ended control.

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170. Santa Fe Indus. v. Green, 430 U.S. 462 (1977).

171. *O'Hagan*, 521 U.S. 642.

172. Ease of enforcement by a federal agency is part of the reason why we make a federal case of insider trading liability.

173. *Chiarella*, 445 U.S. 222 (finding no 10b-5 liability for corporate outsider because there is no fiduciary duty to shareholders or buyers and sellers of securities; suggesting, however, potential liability under the theory of misappropriation).

174. *Dirks*, 463 U.S. 646 (holding that a corporate tippee was not liable under 10b-5 where there was no promise to keep non-public information in confidence and where there was no breach of fiduciary duty by the tipper).

175. *O'Hagan*, 521 U.S. 642 (holding that criminal liability under 10b-5 may be sustained under the misappropriation theory).

176. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. (forthcoming 2009), *available at* http://ssrn.com/abstract=1335494.

3. Open-Ended Control

Professor Ribstein's theory focuses on the kind or degree of control delegated to officers and directors.

> Fiduciary duties are a type of contract term that applies, in the absence of a contrary agreement, where an "owner" who controls and derives the residual benefit from property delegates open-ended management power over property to a "manager." This relationship is referred to throughout the article as the "paradigm" case for fiduciary duties. In such a relationship the fiduciary has the incentive to use control to enrich herself rather than the owner. The owner is best protected by judicially reviewing the fiduciary's conduct to determine whether she has engaged in self-dealing.[177]

In a public corporation, we typically consider the officers and directors to be in complete control over the firm's business decisions with little to no meaningful input from shareholders or other corporate constituents. The business judgment rule and the narrow definition of the duty of loyalty as it applies to corporate managers perpetuate the belief that officers and directors are free to make independent, albeit good faith, judgments about what is best for the corporation. This is the open-ended control to which Ribstein refers: we tell managers to maximize corporate value, but we do not tell them how. Courts have consistently resisted attempts by shareholders to rein in managerial decision making about topics ranging from the distribution of dividends[178] to executive compensation.[179] The decision making authority has been vested in the board and the managers it chooses because of their expertise, and shareholder recourse against poor decision making is limited and arduous.[180] While such independence and seemingly open-ended control and exclusive decisional authority may be the basic premise upon which the law of corporate governance has been built, we will see that enhanced monitoring by various creditors, institutional creditors, and market analysts, as well as greater government reporting requirements and additional government oversight, has decidedly closed the once open end of managerial control.

a. Looking over Their Shoulders

While corporate law does not tell managers exactly how to maximize value, other mechanisms constrain the means to achieve corporate objects. When the corporation is in good financial health, corporate officers and directors probably remain the most free to make whatever decisions they deem best. When a corporation is in significant financial trouble or has had to reorganize its debt, covenants in loan agreements with creditors can serve to limit the managers' decision making authority by limiting the actions the corporation can take without defaulting on its loans.[181] A default on a loan can be

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177. Ribstein, *supra* note 2, at 215.

178. *E.g.*, Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585 (Del. Ch. 1987).

179. *See* Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (finding that corporate discretion regarding executive compensation can be overcome only if the plan is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration").

180. *See supra* Part I.E.

181. Baird & Rasmussen, *supra* note 71, at 1231–32.

catastrophic, because default on one obligation often constitutes a default on all others, so a corporation could be forced into bankruptcy because of the domino effect of the violation of one covenant.[182] This almost never happens, of course, because such a result would not be much better for creditors than it would be for the company. However, creditors use the leverage afforded them by that threat to compel corporate managers to negotiate stricter covenants in a reorganization of the loan or to appoint officers of the creditors' choosing to the firm's executive team.[183] Other loan terms can go beyond specific rules regarding corporate action and investment by applying corporate governance standards. For example, many loan covenants require management to take particular action or not take others. Managers may contradict those orders to the extent that their decision could not reasonably be expected to result in a material adverse effect on the corporation's ability to repay its debts.[184] These terms ultimately allow creditors to challenge management's reasonable expectations in making decisions that result in a material adverse effect, thereby giving creditors an opportunity to declare a default on a loan and push a corporation into bankruptcy if the corporation has been harmed by its managers' poor judgment.

Federal securities law enhanced its previously limited regulation of corporate governance through greater disclosure requirements for publicly traded corporations in the Sarbanes-Oxley Act of 2002 (SOX).[185] SOX requires corporate officers to certify detailed financial disclosures and subjects them to significant monetary penalties if the disclosures are incorrect or misleading.[186] Further, the SEC has encouraged the securities self-regulatory organizations (SROs), including NYSE, NASDAQ, and AMEX[187] to adopt requirements for the listed companies. For instance, all three of these SROs require listed companies to staff their boards with a majority of independent directors and to form a board nominating committee.[188] They also require that listed companies "implement and publicly disclose a code of ethics which must, at minimum, address conflicts of interest, corporate opportunities, confidentiality, fair dealing, the protection and proper use of the company's assets, and compliance with laws, rules, and regulations."[189] This development is particularly interesting because those ethical dilemmas are exactly those that fiduciary duties are already supposed to resolve. In fact, the limited reaches of the

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182. *Id.* at 1232.

183. *Id.* at 1233.

184. Alces, *Strategic Governance*, *supra* note 17, at 1076–77.

185. Pub. L. No. 107-204, 116 Stat. 779 (codified as amended at 15 U.S.C. §§ 7201–7266 (2006) and in scattered sections of 15 U.S.C., 18 U.S.C., 28 U.S.C., & 29 U.S.C.); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 910 (2003).

186. Sarbanes-Oxley Act § 304; 15 U.S.C. § 7243(a) (2006).

187. These acronyms refer to the New York Stock Exchange, the National Association of Securities Dealers, and the American Stock Exchange, respectively.

188. *See, e.g.*, New York Stock Exchange, Listed Company Manual §§ 303A.09, 303A.10, *available at* http://www.nyse.com/Frameset.html?nyseref=http://www.nyse.com/regulation/nyse/11825081.24422.html&displayPage=/lcm/lcm_section.html (last visited Feb. 3, 2009) [hereinafter NYSE]; American Stock Exchange, Company Guide, §§ 802–03, *available at* http://wallstreet.cch.com/AMEX/CompanyGuide (last visited Feb. 3, 2009); *see also* NASDAQ Corporate Governance: Summary of Rules Changes (Nov. 2003), *available at* http://www.nasdaq.com/about/CorpGovSummary.pdf (last visited Feb. 3, 2009).

189. Kelli A. Alces, *Moving Toward a Federal Law of Corporate Governance in Bankruptcy*, 31 S. ILL. U. L.J. 621, 625 (2007).

corporate duty of loyalty include conflicts of interest and corporate opportunities. Guidance about how to address confidentiality, fair dealing, and the proper use of the company's assets would hardly be required for fiduciaries who are already supposed to have an internal compass to guide them through such waters. Further, if those duties were incapable of becoming stated contract terms, they could not be properly articulated in a code of ethics.

b. "Don't be Conflicted Without Permission"

The agency cost theories center around a concern that corporate managers will engage in self-dealing, honoring personal interests that conflict with corporate interests. They argue that these conflicts of interest are exactly what fiduciary duties are designed to address.[190] While that characterization of corporate fiduciary duties has merit, particularly given the limited nature of the duty of loyalty, the duty to avoid conflicted interests need not be fiduciary. Rather, it seems like a provision that could be included in an officer's or director's contract with the corporation and precisely enforced. Only those conflicts of interest that are specifically approved by the corporation will be allowed. All others will subject the manager to personal liability. The trouble comes, of course, with defining conflict of interest. Do we now include egregious failures of care?[191] Financial conflicts of interest are easier to identify than shirking that rises to the level of fiduciary breach. The appropriate response here is that the duty of care is not fiduciary and that we are able to enforce standards of care without regard to fiduciary principles in many relationships that no one would contend are fiduciary at all. We are left with a simple command—"don't be financially conflicted without permission"—that is not difficult to enforce via a simple contract term in a world where it is possible to contractually enforce management standards, as demonstrated by corporate loan covenants.

4. Summary

While the agency costs theory of corporate fiduciary duty is the dominant and pervasive one, there are other and better ways to manage agency costs. From enhanced monitoring to federal securities laws, investors of all kinds are disciplining managers in more direct ways than they have before. They have defined an acceptable code of conduct for officers and directors and have shied away from the expensive and unpredictable process of corporate governance through fiduciary duty enforcement. Because we have developed new ways to ensure that management behaves as it should in pursuit of corporate wealth maximization, the corporate legal system has stopped using fiduciary duties as the preferred method of discipline.[192] Scholars have pointed out that where other mechanisms have been adopted to reduce agency costs and manage a relationship, fiduciary duties are not necessary, so a fiduciary relationship does not exist.[193] The law of corporate governance has reached that point. As publicly traded

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190. *See generally* Ribstein, *supra* note 2.

191. *See supra* Part II.E.

192. *See* Fischel & Bradley, *supra* note 105, at 271–74 (discussing the negative effects of the derivative suit).

193. *See, e.g.*, Cooter & Freedman, *supra* note 3, at 1067 ("Under . . . contracts that provide perfect incentives, the fiduciary relationship is replaced by market exchange."); Frankel, *supra* note 5, at 811 ("If the

corporations continue to define explicitly how their officers and directors are to perform their duties and creditors exercise more and more control, the arrangement between the corporation and its investors on the one side, and the management on the other, will more closely resemble a contractual relationship rather than a fiduciary one. The parties will be able to develop better incentives that replace the fiduciary relationship with specific contract terms.[194] The next Part considers the distinction between the two kinds of interaction and offers an explanation for why the corporate governance relationships more closely resemble non-fiduciary contracts.

D. Fiduciary Relationships v. Contracts

Scholars continue to debate whether fiduciary relationships are simply contractual relationships or are a special breed of consensual interaction.[195] The debate is an important one, particularly in the corporate context, where the relationship between the corporation and its managers and shareholders does not fit neatly into either contract or fiduciary law. Some commentators have taken exception with the "nexus of contracts" approach,[196] now widely accepted as the preferred description of the nature of the corporate form,[197] because shareholders do not seem to be really aware of, let alone bargain for or consent to, the "terms" of their agreement with the corporation and its managers.[198] Still, corporate fiduciary duties have so atrophied that they hardly fit within traditional fiduciary doctrine.[199] To confuse matters further, courts often insist that creditors are not owed fiduciary duties because their relationships with the corporation are governed by contract.[200] Even though all fiduciary relationships are contractual, not

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entrustor can protect himself from abuse of power, there is no need for the intervention of fiduciary law.").

194. Cooter & Freedman, *supra* note 3, at 1067 (demonstrating that a contractual relationship reduces the incentive for an agent to appropriate or mismanage).

195. *See, e.g.*, *id.* (describing fiduciary duties as contractual terms that are necessary to fill gaps in incomplete contracts where the transaction costs of negotiating more precise terms are prohibitively high); DeMott, *supra* note 8, at 887 (firmly rejecting the contention that fiduciary duties are no more than contractual gap-fillers by pointing out that once a relationship is deemed fiduciary, principles of fiduciary law apply to supercede the intent of the parties in making their agreement); Victor Brudney, *Corporate Governance, Agency Costs, and The Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) [hereinafter Brudney, *Corporate Governance*] (rejecting the contractarian view of corporate governance); Brudney, *Contract and Fiduciary Duty*, *supra* note 8, at 641–42 (noting the decline of corporate fiduciary duties and suggesting that senior security holders be protected against common shareholders through contract).

196. *E.g.*,Velasco, *supra* note 23.

197. Bainbridge, *supra* note 38, at 9.

198. *See, e.g.*, Brudney, *Corporate Governance*, *supra* note 195, at 1415–16 ("[T]o impute to investors knowledge of either the terms of the law when they first enter the 'contract' or the changes in the law while stock is held is pure fiction in the case of most individual investors. In the case of institutional investors or market professionals who advise individuals about investments, it is hardly less."); Robert C. Clark, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (J. Pratt & R. Zeckhauser eds., 1985) (noting problems with the nexus of contract approach focusing on actual rather than implied legal doctrine).

199. Brudney, *Contract and Fiduciary Duty*, *supra* note 8, at 629 ("Currently imposed corporate fiduciary obligations substantially dilute classic fiduciary restrictions.").

200. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 199 (Del. Ch. 2006) ("In a situation when creditors cannot state a claim that such contractual protections have been breached and cannot prove a fraudulent conveyance claim, the creditors' frustration does not mean that there is a gap in the remedial fabric of the business law that equity should fill."); N. Am. Catholic Educ. Programming Found. v. Gheewalla,

all contractual relationships are fiduciary. This Part of the Article will consider how contract and fiduciary law fit together in the law of corporate governance and will conclude that the relationships among the corporation's managers and shareholders are more akin to contractual relationships without fiduciary obligation.

The corporate law is the default contract, albeit with some mandatory terms, between the corporation and its shareholders.[201] This contract defines the terms upon which the corporation's relationships with its shareholders and managers are built. Shareholders find out from corporate law what they may expect of managers and what those managers will be required to do on behalf of the corporation.[202] Corporate law, through standards of fiduciary liability and statute, decides what directors and officers owe to the corporation and how they must perform their duties and allocate their loyalties.[203] With the common and statutory law serving as a contract to which shareholders agree when they purchase stock in a company incorporated in a given jurisdiction, the "negotiation" between the contracting parties is unorthodox indeed.

Easterbrook and Fischel argue that a fiduciary relationship is one "characterized by unusually high costs of specification and monitoring."[204] The widely dispersed and uninformed nature of shareholders in public corporations accounts for the high transaction costs that justify the application of fiduciary duties in the corporate context.[205] They claim that the cost of specifying exactly how corporate officers and directors are to do their jobs in a manner designed to maximize the company's wealth is so high that we must rely on a contractual term imposing fiduciary obligations to engage a court to provide the terms that the parties cannot, according to how the parties would

No. Civ. A. 1456-N, 2006 WL 2588971, at *13 (Del. Ch. Sept. 1, 2006) ("Indeed, it would appear that creditors' existing protections—among which are the protections afforded by their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy law—render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary."); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature. . . . The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.").

201. *See* Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444 (1989) [hereinafter Easterbrook & Fischel, *The Corporate Contract*] ("[C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. . . . Corporate codes and existing judicial decisions supply these terms 'for free' to every corporation, enabling the venturers to concentrate on matters that are specific to their undertaking."); John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 939–40 (1988) ("Although corporate law has moved far from its original position, which saw corporations as quasi-public bodies, to become a largely enabling body of law, most state statutes remain mandatory on at least a number of important points.").

202. *See* Easterbrook & Fischel, *The Corporate Contract*, *supra* note 201, at 1418 ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.").

203. *See id.* (describing how corporate law sets terms that shape corporate governance).

204. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 427.

205. *Id.* "Managers owe fiduciary duties to equity investors, but not debt investors or employees, because these claimants can contract at low cost, while the costs of specification are prohibitively high for residual claimants." *Id.* at 437.

have negotiated the term had they thought to do so ex ante.[206] That is, the court formulates the hypothetical bargain of the parties to determine how the contract governs circumstances it did not contemplate.[207]

Easterbrook and Fischel describe a continuum of contractual relationships with those negotiated with very low transaction costs at one end and those where the costs of specifying contractual terms are much higher at the other.[208] Somewhere along the continuum, we reach fiduciary relationships.[209] They argue that contract law requires "good faith in implementation—honesty in fact under the Uniform Commercial Code, plus an obligation to avoid (some) opportunistic advantage taking."[210] Contracts containing a good faith requirement "merge" into fiduciary relationships "with a blur and not a line"[211]—it is simply a subtle move down the continuum that separates relationships between creditors and corporations from the relationship between managers and the corporation. This Article argues that the way courts are ruling on breach of fiduciary duty cases in Delaware, and the other monitoring mechanisms the market has come up with to close the "gaps" left in corporate governance discipline, have moved the once "fiduciary" contract between corporate managers and the firm down the continuum to a place that is no longer necessarily fiduciary.

One significant difference between the way courts interpret typical contracts, fiduciary or otherwise, and the way they approach cases in which breaches of corporate fiduciary duties are alleged is that courts in the corporate fiduciary cases are in a position of having to deliver much more maximalist[212] opinions. The Delaware corporate law *is* the contract between corporations and their managers and shareholders. For that reason, the Delaware Supreme Court may be more interested in using an opinion as an opportunity to clarify terms of that contract generally, as it applies to all corporations organized in Delaware, than with just deciding the dispute before it. Whether such dicta actually serve as an "enforceable" part of the corporate contract is an open question.[213]

206. *Id.* at 427 ("[C]ourts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced.").

207. *Id.* at 431 ("A court setting out to protect principals from their agents *must* use the hypothetical contract approach; the only alternative is to injure the persons the rule makers want to help.").

208. Easterbrook & Fischel, *Fiduciary Duty*, *supra* note 3, at 438 ("When transaction costs reach a particularly high level, some persons start calling some contractual relations 'fiduciary' . . . .").

209. *Id.* at 438.

210. *Id.* (citing U.C.C. § 1-201(19); E. ALLAN FARNSWORTH ON CONTRACTS § 7.17a (2d ed. 1990)).

211. *Id.*

212. Cass R. Sunstein, *Minimalism at War*, 2004 SUP. CT. REV. 47, 48–49 ("Many judges are minimalists; they want to say and do no more than necessary to resolve cases. . . . Maximalists reject shallowness in favor of depth. They are committed to large-scale theory . . . . [M]aximalists want to adopt a foundational account of one kind or another.").

213. One situation in which the response to dicta got a little out of hand was in how to handle the question of whether creditors were owed fiduciary duties in the zone of insolvency. *See* Ribstein & Alces, *supra* note 28, at 538–44. Courts mentioned in dicta that creditors were owed fiduciary duties when the corporation was insolvent, *see, e.g.*, Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992), and, at times, speculated that the same may hold true in the zone of insolvency, *see, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). It took two decisions by the Delaware Supreme Court, *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004), and *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2007), to declare once and for all that such a duty was not owed to creditors, but to the corporation, and that creditors did not even acquire standing to enforce that duty on the corporation's behalf

Nevertheless, such musings by the court send important signals about how it will interpret the corporate contract in subsequent cases, and so cannot be ignored. For example, when the Delaware Supreme Court hears a case alleging breach of fiduciary duty by corporate directors, it may use the opportunity to describe the standards by which directors must comport themselves and situations in which a director may be held liable for similar failures even if it is not imposing liability against the directors in the case before it.[214] The significance of this phenomenon to corporate fiduciary duties is that, unlike other fiduciary contracts, the court is not just filling the gaps in a discrete contract before it. Because the contract before it is a standard form, a default contract that applies to many interested parties, the court must do much more than that.

If we appreciate the Delaware courts as the actual negotiators of the corporate contract that set the standards and guide the enforcement of all corporate governance provisions, then we begin to see litigation as a very costly way of specifying contract terms that we claim are too expensive for the parties themselves to negotiate. This is one unusual, and possibly problematic, consequence of understanding a body of law as a contract. Movements in the common law change the "contract" to which a number of parties are subject.[215] The "negotiation" courts are able to accomplish regarding the duties officers and directors owe may raise some questions about the necessity of fiduciary duties, and so also about their existence, in corporate governance. If courts are able to design standards for corporate governance without a particular controversy requiring the imposition of liability for breach of those standards in front of them, why is it that the transaction costs are too high for corporations to do the same when negotiating "contracts" with their directors and officers? We have used fiduciary duties as an excuse to let courts do the negotiating that we say is too expensive for the parties to do themselves, but the courts are, in fact, negotiating just as the parties would, in a vague way that does not respond to particular circumstances the parties could not have anticipated. Courts, rather than corporations, are devising standards to address behavior in such a way that those standards can respond to a variety of potential behaviors. The particular facts of managerial corruption may be difficult to predict, but the standards of behavior that would prevent the particular kinds of malfeasance for which we are willing to impose personal liability are not at all difficult, or impossible, to formulate.

If we accept the foregoing, then what is the problem with allowing the parties involved to negotiate particular terms that will move the corporate governance contracts away from the fiduciary end of the continuum? Easterbrook, Fischel, and others claim

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until the firm was actually insolvent. "[T]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency." *Gheewalla*, 930 A.2d at 101.

214. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367–70 (Del. 2006); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. Ch. 2006). Both of these opinions included lengthy discussions of the standards for the good faith and duty of care fiduciary duties in the corporate context before affirming dismissal of the shareholders' claims and imposing no liability upon the boards of directors.

215. Perhaps this gives rise to some of Clark's hesitation in conceding that a corporation is a nexus of contracts. He claims some difficulty with the notion that corporate law is like a freely entered and bargained for agreement between willing parties. Clark, *supra* note 198, at 60–61. Since "[fiduciary] duties are highly unlikely to have been the result of any actual compact or understanding between manager and investor," Clark asserts that the characterization of corporate law as contract is more metaphorical than actual. *Id.* at 61.

that the widely dispersed nature of equity holders is to blame.[216] However, that does not seem to be a problem anymore because we have all but acknowledged that shareholders are not the primary beneficiaries of corporate fiduciary duties, if they are indeed beneficiaries at all.[217] The corporation itself is the beneficiary and should be able to negotiate with officers and directors about the particular standards of behavior that should apply to their operation of the company as they negotiate other terms of management contracts. While such standards may not yield specific managerial guidelines or benchmarks—and, indeed, may not be as specific as loan covenants—they still may describe the way officers and directors are to perform their duties so that breaches of those terms could be prosecuted as breaches of contract without resort to the intentionally broad and amorphous doctrine of fiduciary obligation. Corporate contracts with creditors frequently set standards and tasks for corporate officers and directors[218] and include enforcement mechanisms without requiring the benefits of fiduciary duties.[219] If the corporation can negotiate with creditors, even about standards of managerial behavior, it should also be able to negotiate with its own managers.

Of course, the typical problem that confronts suits for breach of fiduciary duties rears its ugly head again—we would be asking officers and directors to enhance the standards of their own performance. Fortunately, corporate governance has been finding ways to circumvent that problem. First, corporate managers should already be in the practice of defining standards for the performance of their duties at a certain level of care and loyalty because they have been writing and publishing codes of ethics for several years.[220] Corporations can devise standards of corporate governance and then can compete on the market for investors, much the way states compete for incorporations.[221]

216. Easterbrook & Fischel, *Fiduciary Duties*, *supra* note 3, at 437 ("Managers owe fiduciary duties to equity investors, but not debt investors or employees, because these claimants can contract at a low cost, while the cost of specification is prohibitively high for the residual claimants."); SHEPHERD, *supra* note 10, at 351–59 (discussing the distinction between the relationship that directors have with the corporation, the majority shareholder(s), and shareholders as a whole); Baird & Henderson, *supra* note 15, at 1310–13 (discussing the various investors involved in the average corporation and the potential problems with such diversification of control).

217. *See supra* Part I.B. ("To the extent officers and developers owe fiduciary duties, they owe those duties to the corporation itself . . . .").

218. Alces, *Strategic Governance*, *supra* note 17, at 1073–78.

219. Indeed, creditors have been denied the protection of fiduciary duties particularly because they are able to negotiate contracts with the corporation this way. *See, e.g.*, N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99–101 (Del. 2007); Production Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004).

220. Sarbanes-Oxley Act §§ 404, 406, 15 U.S.C. §§ 7262, 7264 (2006). These provisions not only require that corporations enact their own ethical requirements for their officers and directors and internal control structure but also require public disclosure of these standards.

221. For over 30 years, Delaware has been accused of leading the "race to the bottom"—that is, creating corporation and manager friendly state laws to encourage corporations to charter in Delaware. Critics argue that such a race leads to lower standards for corporate accountability. *See, e.g.*, William L. Cary, *Federalism and the Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). While the idea of the race to the bottom is still discussed today, some scholars are concluding that the race is over since no other state is prepared to challenge Delaware's level of leniency in corporate law, and that allowing Delaware to assume this position of supremacy is actually beneficial to American corporate law. *See, e.g.*, Lawrence Hammermes, *How We Make Law in Delaware, and What to Expect from Us in the Future*, 2 J. BUS. & TECH. L. 409, 411 (2007); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over*

That should discipline the managers to require high standards of corporate governance—or at least to strike a balance between too much liability and too little accountability in a way that courts have failed to do on a case by case basis. The enhanced certainty provided by more specifically negotiated contracts should resolve some of the fears of significant and unpredictable liability and make managers more comfortable submitting to higher standards of corporate governance so long as their duties and the potential consequences of deviation from those standards are clearly laid out and agreed upon from the outset. Second, if shareholder input is necessary or desirable, there may be a way to give shareholders a voice in the process without resort to fiduciary duties or the courts to bring the corporate governance contracts closer to creditor contracts on Easterbrook and Fischel's good faith/fiduciary duty continuum. In the next Part, I will explain how an "equity trustee" can allow shareholders to negotiate with management with one voice.[222]

IV. REPLACING FIDUCIARY DUTIES WITH CONTRACT TERMS

The relationship between corporate officers and directors and the corporation has always been described as fiduciary. Much of corporate law is organized around the principle that officers and directors owe fiduciary duties to the corporation and its shareholders. That assumption has even played a significant role in insider trading liability.[223] The lack of fiduciary duties will leave a gap in the jurisprudence and in the way we conceptualize corporate governance, even though it need not necessarily leave a void in the way shareholders, other investors, and the market limit the agency costs imposed by the corporate management structure. Once the corporate bar acknowledges that the corporate fiduciary analysis is obsolescent, it can invest more fully in other mechanisms of corporate governance. The seeds for those new and, perhaps, more effective monitoring and disciplinary mechanisms have been planted, and their growth is left to the ingenuity and creativity of the market, corporate investors, corporate managers, scholars, and the courts.

This Part of the Article considers some ways corporate governance could adapt to more effectively navigate a post-fiduciary corporate world. It begins by briefly explaining why corporate law is still so preoccupied with fiduciary duties and what place the fiduciary system seems to hold. It then supports a new way of thinking about corporations, or a more complete view of an old way of thinking about corporations: as a nexus of contracts with various constituents and investors of various kinds,[224] all bargaining for the rights to corporate control warranted by the kind of investment they

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Corporate Charters, 112 YALE L.J. 553 (2002).

222. Alces, *Strategic Governance*, *supra* note 17, pt. V (suggesting the use of an "equity trustee" to represent shareholder interests to management when the corporation is in serious financial trouble).

223. *See supra* Part III.C.2.b ("Fiduciary duties have long been considered the basis for a prohibition of insider trading.").

224. This view of the corporation as a nexus of contracts is now the prevailing one, developed by scholars over the last couple of decades. *See, e.g.*, EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 13, at 6–7; Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 819–20 (1999); Henry Butler, *The Contractual Theory of the Corporation*, GEO. MASON U. L. REV., Summer 1989, at 99. More particularly, Margaret Blair and Lynn Stout describe a corporation as a team of units of production, all contributing to the corporation in different ways, organized under the board of directors. Blair & Stout, *supra* note 24, at 276–79.

make. Next, it suggests a way that this view of the corporation can more effectively include shareholders as investors with a negotiating position with the corporation equal to that held by creditors. Shareholders may achieve this equality through the use of an "equity trustee," a representative of the cohesive shareholder position in a given corporation that brings the widely dispersed, rationally apathetic shareholders to the bargaining table in the form of a single, informed delegate. Finally, the Part discusses ways to hold misbehaving managers more accountable through the enforcement of relevant contract terms.

A. Why Are We Still So Preoccupied With Fiduciary Duties?

In his book about fiduciary law and its application to particular relationships, Shepherd declares that "[t]he fiduciary relationship between director and corporation is unquestioned. It is the cornerstone of the directors' office, and as such has become trite law."[225] We have always supposed that directors are fiduciaries of shareholders and the corporation and that that fiduciary position defines how directors are to behave in managing the assets of others.[226] Until recently, no one has questioned whether the relationship between corporate managers and the company *should* be fiduciary.[227] While Shepherd claims that the emperor of fiduciary obligation owed by corporate managers to the corporation "has no clothes," he asserts that "a parallax has been created that makes him look as if he has clothes."[228] He ultimately concludes that corporate officers and directors are indeed fiduciaries because of the powers conferred on directors for use for the benefit of others.[229] He argues that practical considerations stand between achieving a consistency between fiduciary theory and corporate law.[230] Still, because of the basic corporate construct—a board of directors presiding over a company consisting of assets owned by the firm's investors—the relationship between directors and the corporation has always been considered fiduciary and has never been viewed otherwise.

Fiduciary duty analysis is not without value in corporate law. Potential liability for fiduciary breach plays an important role in deterring managers from taking advantage of their position in order to use corporate assets for their own advantage. Further, it gives shareholders, or their attorneys, a framework within which to monitor director behavior and a standard that the behavior must meet. The corporate fiduciary duties, such as they are, guide corporate managers' operation of the business. The fiduciary paradigm tells them the extent to which they are to consider the interests of others and, now, the extent

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225. SHEPHERD, *supra* note 10, at 355 (citations omitted).

226. Velasco, *supra* note 23.

227. In *Other People's Money*, Baird & Henderson argue that corporate law should eliminate fiduciary duties, but do not go so far as to say that it already has. Baird & Henderson, *supra* note 15, at 1313–17.

228. SHEPHERD, *supra* note 10, at 16–17.

229. *Id.* at 352–53.

> Within the corporate structure, the legal fiction which is the corporation is at once a beneficiary and the corpus of a trust. A corporate director has a fiduciary relationship at least to the corporation, in some cases also to shareholders, and, if elected to represent a particular class of persons who are interested in the corporation, to that class.

Id. at 351.

230. *Id.* at 359 ("[E]ven if theory and reality do come together . . . the *application* of fiduciary principles to corporate situations will continue to be heavily restricted by practical considerations.").

to which they may consider interests other than those of shareholders in making decisions on the corporation's behalf. It defines the contours of their decision making authority and the limits of their personal liability. It is the standard Delaware law provides for the discipline of corporate management; it is unchallenged by any other system.

There are dangers in relying too much on corporate fiduciary duties. Such reliance may give shareholders a false sense of security that prevents them from using their other powers more effectively and from devising new ways to monitor officers and directors. Uncritically assuming that fiduciary duties are all the governance standards and enforcement mechanisms we need in the law of corporate governance prevents the law from evolving with changes in the market to create mechanisms that reduce managerial agency costs. It is worthwhile to turn now to some of those new methods and suggest ways courts may adapt their corporate governance reasoning to effect those innovations.

B. All Investors Created Equal—Bargain for Different Rights and Roles

As the market for publicly traded securities has grown in size and sophistication, the line that once separated debt and equity has blurred. Baird and Henderson pointed out that, "[a] high-yield junk bond (creditor) and ordinary equity (shareholder) are similar to each other, not only with respect to cashflow rights, but also with respect to control rights."[231] The distinctions between the forms of investment are, therefore, not sacrosanct and not necessarily based on some principled judgment about to whom fiduciary duties are owed or a law affording specific rights to each kind of investor. Rather, creditors have been able to achieve through contract what shareholders have under the terms of corporate law and, in fact, have reserved more power for themselves in loan covenants than shareholders could legally claim, and have been able to do so without the benefits of fiduciary duties.[232] What if we thought of shareholders as nothing more than the most junior creditors? What if shareholders did not have a special place carved out in the corporate law, but were able to negotiate with management about the rights they would have over corporate governance?

The distinction between creditors and shareholders is well reasoned. Shareholders are the residual claimants, the "owners" of the corporation. Corporate law, therefore, must protect them from some of the failures of corporate managers. Shareholders are widely dispersed in public corporations and rationally apathetic. We do not want them to run the business, but we do not want those running the business to steal from the corporation. Because of their relative lack of sophistication and the collective action problem, shareholders are perceived as unable to contract directly with the corporations in which they invest for rights and protections. Therefore, the corporate law provides the contract for them and decides what those rights and protections should be. Creditors, on the other hand, are able to contract directly with the corporation through representatives and engage in negotiations that lead to detailed contracts outlining the terms of their investments. Even bondholders, dispersed holders of public debt securities, have such representation in an informed indenture trustee. Granted, the indenture trustee is not a

231. Baird & Henderson, *supra* note 15, at 1338.

232. *See* Alces, *Strategic Governance*, *supra* note 17, at 1066–67 (arguing that creditors have achieved more direct power and influence than shareholders through contracts); Baird & Henderson, *supra* note 15, at 1338–39.

powerful representative,[233] but its existence demonstrates that it is not impossible for widely dispersed public security holders to negotiate directly with the corporation over the terms of their investment, their ability to monitor the firm and its management, and the remedies available when things go wrong. Momentum and a virtually abandoned belief that shareholders are adequately represented by management have prevented us from seeing that shareholders can claim the same advantages available to creditors and carefully negotiate contracts that stand in equal dignity, if not priority, to the other investment contracts making up the corporate team.

Perhaps the rights shareholders would negotiate for would still include the right to elect corporate directors in keeping with the corporate law principle of giving the most "control" to the party bearing the most risk, commonly the residual claimant. The degree to which shareholder control rights can be deemed superior to the rights of others is dwindling. Institutional lenders are able to exert great control in loan covenants and are able to act in a more concerted and organized fashion to protect their contractual rights; shareholder powers seem almost meaningless in comparison.[234] It is creditors who are able to directly influence who serves as a corporate executive.[235] Shareholders may do so only indirectly through a vote on directors.[236] In troubled times, creditors are able to closely monitor the company and protect their investment through the ability to declare a default (or forebear from declaring a default). The quantum of control creditors can exercise over the corporation and its management during troubled times is enviable.

Far from arguing that shareholders (or anyone) should maintain a high degree of control over the corporation's management during healthy times, I instead argue that if shareholders stop relying so much on the idea of fiduciary duties, they can find better ways to protect their investments in corporations. If creditors are able to do so well without fiduciary duties, it appears that shareholders may gain more protections against bad faith management by adapting themselves to the creditors' model of bargaining over the terms of their investment.

C. Equity Trustee

The first step in overcoming the shareholders' collective action problem is to give them a representative to the corporation. An equity trustee can serve a similar function as the indenture trustees serving bondholders by representing the interests of the shareholder class to management in defining terms of the contract that shareholders will buy on the market. The better the shareholder contract, the more likely the market is to favor that corporation's stock. It provides a way to replace the state laboratories for corporate

233. Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 458 n.41 (1999).

234. Baird and Rasmussen argue that the control vested in private creditors actually serves as a valuable check on the inner workings of the corporation. Baird & Rasmussen, *supra* note 71, at 1212 ("Loan covenants now are the principal mechanism for handling one of the most challenging problems in corporate governance, the one that arises when a once-effective manager needs replacing and the operations of the business must go through a fundamental overhaul.").

235. Baird & Henderson, *supra* note 15, at 1338; Baird & Rasmussen, *supra* note 71, at 1211. Both of these articles note that creditors, unlike shareholders, hold an enormous amount of power over a corporation's board of directors, including having a direct say in the hiring or firing of corporate executives.

236. BAINBRIDGE, *supra* note 167, at 440–41.

contracts with corporate laboratories[237]—each firm has the chance to compose the contract with the best terms for shareholders as balanced against other corporate interests. Shareholders will prefer the contracts that treat them the best without compromising corporate performance. That means a contract is not superior because it gives the shareholders the most rights, but because it gives them the most rights without compromising the corporation's ability to maximize its wealth. At the end of the day, shareholders still want to realize a return on their investments. Shareholder contracts would require provisions similar to those found in creditor contracts, such as disclosure requirements, special announcements upon the occurrence of specified events, and the revelation of potential changes to the company's capital structure. The existence of a shareholder representative—combined with specifically chosen rights in a shareholder contract—can afford shareholders the ability to exercise more effectively the powers granted them by corporate law.

With an equity trustee advising shareholders how to vote in a manner that is consistent with their interests within a particular corporation,[238] shareholders can summon enough votes to make their voices heard and their influence felt. Shareholder contracts would complement, rather than replace, existing corporate law.[239] However, as shareholders realize more advantages to particular contracts negotiated by an equity trustee, the terms of the default contract provided by corporate law may become obsolete. Allowing shareholders to negotiate with management through a representative closes the gap left by corporate fiduciary duties by acknowledging the reality of management's role and relationship to the corporation and its shareholders. It also achieves a more literal nexus of contracts in the corporation. If shareholders are negotiating terms through a representative with undivided loyalty and can choose among several possible contracts on the market, then the arguments that shareholders are not engaged in a contractual relationship with the corporation or its managers fail.

Of course, there are important practical considerations. One professional or a firm of professionals could be an equity trustee. Corporate consultants or proxy advisors could provide the service, subject to the constraints against conflicts of interest, and could hire outside professionals to guide their representation of shareholders. The equity trustee

237. One of the primary justifications for leaving corporate law to the states is that it provides 50 laboratories in which to experiment and find the best corporate law. Delaware seems to have won that race so far. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) ("States . . . are said to use their corporate law to compete for corporate tax revenue and ancillary benefits; Delaware has 'won' that race . . . ."); Bebchuk & Hamdani, *supra* note 221, at 586 ("Delaware faces a very weak threat of a challenge by another state."); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1954 (1998) ("Participants in the state competition controversy agree that, to date, Delaware is the undisputed winner."). By substituting contracts for fiduciary duties, each company has a chance to put together a contract that it can sell on the market to shareholders.

238. It is true that shareholders will have diversified portfolios and that some shareholders may have investments whose success conflicts with the best interests of the corporation at issue. That does not prevent the equity trustee from being an effective shareholder representative. While individual investors may have conflicting interests, the shareholder interest in any one corporation is readily identifiable and the only object of that equity trustee's fiduciary duties.

239. One may argue that the logical conclusion of the shift in corporate governance this Article anticipates obviates a need for defining shareholder duties in corporate law rather than allowing corporations to provide for them in contracts with shareholders. If we see the corporate law as a default contract, then that may prove a more economical way of setting a starting point for shareholder rights.

would be chosen by a committee of the corporation's seven largest shareholders as measured at a predetermined time each year.[240] One difference between equity trustees and indenture trustees that is required by the widely dispersed nature of shareholders, combined with the residual nature of their claim retention, is the payment of the representative. Indenture trustees can be paid from the recovery promised bondholders. Because no such fixed or predictable payment is coming to shareholders, equity trustees must be paid by the corporation. This payment effectively comes from the shareholders' residual claim, at least when the corporation is solvent.[241]

Numerous agency costs would accompany the addition of an equity trustee. For one, it adds yet another agent to the corporate mix, just one more body doing someone else's bidding. In a sense, it replaces the agency costs associated with the shareholder/manager relationship with those associated with the relationship between shareholders and the equity trustee. The equity trustee is a more appropriate fiduciary, however. The shareholders are its clear and only beneficiary, and it is charged with taking action in their best interests and only in their best interests. The equity trustee is an actual fiduciary that shareholders can hold accountable in exactly the ways corporate law once imagined they could discipline corporate managers. If bondholders can count on, and enforce, the loyalty of an indenture trustee, so may the shareholders rely upon the loyalty of an equity trustee.

The fact that the corporation (and so in a sense the very managers the equity trustee is to monitor) pays the equity trustee's fee allows the possibility of conflict of interest. But because the equity trustee is selected by shareholders, not managers, it cannot become too loyal to management. Any equity trustee that spurns shareholder interest in favor of management approval may find his term not extended. Such reputational constraints may prove too little too late for those intent upon stealing or using their position to personal advantage,[242] but such thieves cannot keep us from entering into fiduciary relationships at all. An equity trustee may prove a valuable addition to the corporate governance landscape and provide better monitoring and disciplinary mechanisms to constrain corporate management.

D. Enforcing Corporate Contracts

Increased monitoring by investors also closes gaps we have typically tried to fill with corporate fiduciary duties, and decreases the necessity of trusting managers to behave faithfully. If the contracts are the corporation, enforcing the contracts should protect the corporation. The board's obligation is to balance the various contracts against each other to provide a coherent capital structure. The board negotiates the contracts and

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240. Alces, *Strategic Governance*, *supra* note 17, at 1098. The basic structure of the equity trustee is described in *Strategic Governance*. While that article only recommends the use of an equity trustee when a corporation is experiencing financial difficulty, the basic choices made there about how and when an equity trustee will be chosen and created will apply here. This Article suggests a different role for the same representative.

241. When the corporation is insolvent, junior unsecured creditors replace shareholders as the residual claimants.

242. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 325–30 (2006) (concluding that gatekeepers—those providing certification or verification services to investors—will not always seek to protect their own "reputational capital," and may do so rationally).

understands how they relate to one another and the enforcement of each. We have already mastered the ways to contract with and bind a corporation. How do we reach management through those contracts?

Officers and directors are not likely to guarantee the corporation's performance on its contracts and typically are not parties to them.[243] Baird and Henderson suggest making managers parties to the contracts insofar as they bear personal liability for ensuring that the corporation meets its disclosure obligations in the contract.[244] That could be applied more broadly, of course. The directors and officers could assume personal liability for a number of specified steps that allow investors to exercise their monitoring rights. Then, if the corporation is not doing well and it appears to be management's fault, the investors can take appropriate action to agitate for a change of the guard. If the managers obscure corporate performance from monitoring investors, then there are personal repercussions against the officers and directors. This is, in some ways, the method securities regulations have used to try to provide for greater officer accountability.[245] Investors can now specify exactly what they expect of officers and directors, the managers can agree to those tasks, and liability can be based on breach of contract, rather than on nebulous and poorly defined fiduciary principles. Baird and Henderson refer to such agreements as "voluntary fiduciary duties."[246] I submit that they are voluntary contractual duties governed by the obligation to perform contractual obligations in good faith, and that they live on the "good faith" side of the good faith/fiduciary duty spectrum defined by Easterbrook and Fischel.

V. CONCLUSION

Corporate governance relationships are no longer fiduciary. Delaware law has narrowed the scope of corporate fiduciary duties to the extent that they now only serve to address very specific and limited misbehavior by corporate officers and directors. It has become more and more difficult for shareholders to enforce the duties managers owe the corporation derivatively, and the grounds for liability continue to shrink. Increasingly, we hold corporate managers to a lower standard of honesty, loyalty, and care than we hold other professionals. Such a low bar does not satisfy the fiduciary standard or purpose.

When we consider what fiduciary duties are for and what it means to be a fiduciary, it becomes clear that the paradigm does not describe the relationship a corporation has with its officers and directors. Corporate and securities laws and practice increasingly reveal a distrust of management and a growing assumption that they will hold self interest paramount within the bounds of the law. Corporate governance is evolving to accommodate those changes in the beginning premises about what corporate managers are and how they are supposed to serve the firm. Further, the increased monitoring lowers the agency costs associated with the separation of ownership and control without resort to fiduciary duties, thereby rendering corporate fiduciary duties obsolete. Creditors have

243. Baird & Henderson, *supra* note 15, at 1340–41 (discussing the legal challenges inherent in contracting opt-in disclosure obligations).

244. *Id.*

245. *See, e.g.*, Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243(a) (2006) (describing the forfeiture of performance compensation and profits in the event of material noncompliance).

246. Baird & Henderson, *supra* note 15, at 1340–41.

been able to enforce governance standards through their loan covenants for a long time. The corporation can follow their lead in devising contract terms that replace the role fiduciary duties play in determining the standards of managerial conduct. Because they are so narrow and specifically described, the obligations we impose on corporate managers could be particularly provided for and enforced via contract, and so a fiduciary relationship does not exist.

By coming to terms with the atrophy of fiduciary obligation in corporate governance, corporate law and various corporate constituents can devise more effective ways to constrain the agency costs associated with corporate governance. Recognizing and accepting the creeping irrelevance of corporate fiduciary duties is the first step. Replacing the void left by their absence will be the next.